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No. 23,009

IN THE

**United States Court of Appeals
For the Ninth Circuit**

ROYAL INSURANCE COMPANY, LIMITED,
a foreign corporation,

Appellant,

vs.

THE SISTERS OF THE PRESENTATION,
a corporation,

Appellee.

On Appeal from the United States District Court
for the Northern District of California

BRIEF FOR APPELLEE

TOBIN & TOBIN,

By JOHN J. FORD, III,

1 Jones Street,

San Francisco, California 94102,

Attorneys for Appellee.

FILED

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**On Appeal from the United States District Court
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BRIEF FOR APPELLEE

OPINION BELOW

The Memorandum of Decision by the Honorable W. T. Sweigert, Judge of the United States District Court, appears in the Clerk's Transcript of Record at R. 146-160.

This Memorandum of Decision reviews each of the Issues as presented by the Final Pretrial Conference—Plan of Trial Order (CT 87) and analyzes each issue by applying the facts of this case, as disclosed by the evidence, to the applicable law. The following issues are analyzed in that manner:

- (a) Proof of Loss Issue (CT 147);
- (b) Loss of Insurable Interest Issue (CT 148);
- (c) Increased Hazard Issue (CT 150);
- (d) Actual Damage Issue (CT 152);
- (e) Allowance for Removal of Certain Fixtures (CT 159).

Because this Memorandum of Decision is such a comprehensive analysis of the law as applied to the facts found from the evidence in this case, counsel for appellee has consciously abandoned the pride of authorship usually attendant upon the writing of a Brief for appellee and has adopted all of those citations and analysis in the Memorandum of Decision as they apply to the issues on appeal. Seldom has counsel for appellee seen an opinion that more concisely, more authoritatively, or more completely covers an analysis of not only the evidence relied upon in the findings of facts, the law relied upon to apply to the facts, but also, the conclusions drawn from the application of the law to the facts as shown. For this reason, no novel approach will be assumed in this brief; the Memorandum of Decision is more than adequate to answer all contentions made by appellant in its opening brief.

STATEMENT OF JURISDICTION

The United States District Court for the Northern District of California had jurisdiction to remove from the Superior Court of California in and for the City

and County of San Francisco, where the action was initially filed, pursuant to 28 USC § 1441 (a). Original jurisdiction is based upon § 28 USC 1332 (a) (2), a civil action between a citizen of the State of California and a citizen of a foreign country in which the amount in controversy exceeds \$10,000.00. (RT 2, 3.) This court has jurisdiction of the appeal under 28 USC § 1291.

STATEMENT OF FACTS

(A) The Summary Adjudication of Facts, dated August 16, 1967, as modified by Order dated November 24, 1967, presents the facts as follows:

“1. That title to the real property located at 2116 Jefferson Street, Berkeley, California, was vested in The Sisters of the Presentation, a California corporation, on June 8, 1966;

2. That title to the ‘old convent building’ situate on the premises described in paragraph 1 above was vested in The Sisters of the Presentation, a California corporation, on June 8, 1966;

3. That effective December 1, 1961, in consideration of a premium paid, defendant executed to plaintiff for a term of five years a standard California fire insurance policy insuring plaintiff against loss by fire of that certain building described in paragraph 2 above; that said policy of insurance was in full force and effect on June 8, 1966, and that plaintiff was the beneficiary thereof and owner of the insurable interest therein on June 8, 1966;

4. That as of June 8, 1966, plaintiff has not assigned its title or interest in and to the proper-

ties described in paragraphs 1 and 2 above to the Roman Catholic Bishop of Oakland or to any other person;

5. That the agreement dated April 20, 1964, between the plaintiff and the Roman Catholic Bishop of Oakland did not affect plaintiff's legal title to the properties described in paragraphs 1 and 2 above, nor did said agreement divest plaintiff of its interest in the policy of insurance described in paragraph 3 above or its rights to damages as beneficiary of said policy of insurance;

6. That the contracts entered into by the Roman Catholic Bishop or any other person acting in his behalf relating to the demolition of the building described in paragraph 2 above did not affect plaintiff's title to said building or in any way defeat plaintiff's insurable interest therein as beneficiary under the policy of insurance described in paragraph 3 above;

7. That the building described in paragraph 2 above was damaged by fire on June 8, 1966; . . ."

(B) Correspondence was dispatched between the parties after the fire loss on June 8, 1966 as follows:

(1) *June 17, 1966*: Letter from Tobin & Tobin to Royal Insurance Company, Limited, forwarding proof of loss and appointing appraiser. (Exhibit 1, RT 9.)

(2) *June 21, 1966*: Sworn Statement in Proof of Loss, dated June 21, 1966, submitted by plaintiff in accordance with the provisions of the policy. (Exhibit 1, RT 14.)

(3) *June 29, 1966*: Letter from the General Adjustment Bureau acknowledging receipt on June 23, 1966, of Proof of Loss dated June 21, 1966. This letter sets forth certain objections to the form of Proof of Loss. (Exhibit 2, RT 24.)

(4) *July 7, 1966*: Plaintiff's letter to the General Adjustment Bureau offering to meet with the adjuster and requesting their aid and cooperation in properly preparing the Proof of Loss according to their standards. Further, demand again made for appointment of appraiser. (Exhibit 3, RT 23.)

(5) *July 29, 1966*: Letter from Tobin & Tobin to Augustus Castro extending time to defendant to appoint appraiser. (Exhibit 3, RT 23.)

(6) *August 26, 1966*: Letter from Tobin & Tobin to Augustus Castro requesting evaluation, failing this, demanding arbitration under the terms of the policy. (Exhibit 5, RT 23.)

(7) *September 21, 1966*: Letter from Tobin & Tobin to Augustus Castro demanding arbitration and reviewing entire course of correspondence to date. (Exhibit 6, RT 23.)

(8) *September 22, 1966*:

(a) Letter from Augustus Castro to Tobin & Tobin advising appointment of appraisers would be useless. (Exhibit 7, RT 26.)

(b) Letter from Augustus Castro to Tobin & Tobin objecting to appointment of R. E. Saleme Co., as appraiser. (Exhibit 8, RT 26.)

(c) Letter from Augustus Castro direct to The Sisters of the Presentation requesting examination under oath and production of documents. (Exhibit 9, RT 17.)

(9) *September 28, 1966*: Letter from Tobin & Tobin to Augustus Castro advising that previous religious commitments precluded attendance in accordance with the company's demand; advising availability at other times, answering other inquiries. (Exhibit 10, RT 125.)

(C) *September 28, 1966*: Plaintiff filed its action in the Superior Court of California for the City and County of San Francisco. Said action was subsequently removed to the Federal Court.

(D) *February 13, 1967*: The depositions of Merle W. Garing, Abdo S. Allen, and Clement J. Finney, Jr., were taken.

(E) *February 14, 1967*: Depositions of Mother Mary Thaddea and Sister Mercedes were taken.

At the opening statement, plaintiff's counsel placed upon the blackboard a chronological diagram showing each relevant event set forth above. This diagram demonstrated conclusively that the demolition did not taken place until *after* the fire loss occurred.

ARGUMENT

POINT I

**THE SISTERS DID NOT LOSE THEIR INSURABLE INTEREST IN
THE CONVENT BUILDING BY REASON OF COLLATERAL
CONTRACTS ENTERED INTO PRIOR TO THE FIRE.**

Appellant attempts to fix various times at which the Sisters lost their insurable interest in the convent. Each will be taken in its turn and analyzed to determine if the insurable interest terminated:

(1) *April 20, 1964*—Execution of the agreement with the Bishop (Exhibit A) in evidence:

“Once that Agreement was executed, the Sisters no longer had a pecuniary interest in the old convent’s preservation.” (Appellant’s Opening Brief, p. 15.)

Having made this statement, Appellant immediately retreats from it when he says:

“Arguably, the sisters did not lose *all* of their insurable interest in the old convent when the April 20, 1964 Agreement was executed . . . ,” (Appellant’s Opening Brief, p. 17. Emphasis added.)

This contention was ruled upon initially by Judge Zirpoli in his determination on the Motion for Summary Judgment:

“5. That the agreement dated April 20, 1964, between the plaintiff and the Roman Catholic Bishop of Oakland did not affect plaintiff’s legal title to the properties described in paragraphs 1 and 2 above, nor did said agreement divest plaintiff of its interest in the policy of insurance described in paragraph 3 above or its rights to

damages as beneficiary of said policy of insurance;" (CT p. 62, lines 17-28.)

In his Memorandum of Decision, Judge Sweigert meets this contention directly:

"... that at the time of fire loss the sisters had not otherwise assigned or otherwise parted with their title or interest in the old convent building or to the land on which it stood; that the building still had an insurable potential use and value to the sisters so long as it stood in place and in the event of change of arrangements with the Bishop for any reason (See, *Bomberger v. McKelvey*, 35 Cal. 2d 607, 613-614, 220 P.2d 729, 733 (1950)), a matter with which the defendant company would have no legal concern." (CT 148, line 25 to 149, line 10.)

Directly on this point, dealing with collateral contracts that have an effect upon insurance proceeds, the Court of Appeal of the State of California has clearly defined the state of the law in California:

"Our research has failed to disclose any California authority on the precise point raised by the parties. We find that New York has adopted the rule that an insurer is not entitled to the benefit of the fact that the insured's loss has been cured by the act of a third party, but that its liability under the policy remains unaffected. *We are in accord with the New York rule.* We find the rule first expressed in the case of *Foley v. Manufacturers' & Builders' Fire Ins. Co. of New York* (1897) 152 N.Y. 131 [46 N.E. 318]. In that case, the plaintiffs were the owners of land upon which certain buildings were being constructed. When the buildings were near completion, they

were destroyed by a fire, and plaintiffs sought recovery under their policy of fire insurance. Defendant insurer denied liability, asserting that the building contractor, pursuant to its agreement with plaintiffs, was still obligated to complete the buildings at no additional cost to plaintiffs. The court rejected the insurer's contention, and stated, at page 319 [46 N.E.]: 'But the contract relations between the plaintiffs and the contractors is a matter in which the defendant has no concern . . .'

"The fact that improvements on land may have cost the owner nothing, or that, if destroyed by fire, he may compel another person to replace them without expense to him, *or that he may recoup his loss by resort to a contract liability of a third person, in no way affects the liability of an insurer, in the absence of any exemption in the policy.*" (Emphasis added.)

Hughes v. The Potomac Insurance Co., 199 C.A.2d 239, 250-251, 18 Cal.Rptr. 650 (1962).

Thus, having unequivocally adopted the New York rule regarding collateral contracts, appellant's contentions in this regard must be rejected.

(2) *August 25, 1965*: Date of contract between the Bishop of Oakland and Merle Garing, General Contractor. (Defendant's Exhibit 2, RT p. 224, line 19.)

Appellant contends that either the execution of the contract between the Bishop of Oakland and the general contractor, or the performance thereof, divested the Sisters of their insurable interest in the convent building. (Appellant's Opening Brief, p. 17.)

This contention was first answered by Judge Zirpoli in his ruling on the Motion for Summary Judgment as follows:

"6. That the contracts entered into by the Roman Catholic Bishop or any other person acting in his behalf relating to the demolition of the building described in paragraph 2 above did not affect plaintiff's title to said building or in any way defeat plaintiff's insurable interest therein as beneficiary under the policy of insurance described in paragraph 3 above." (RT 62, lines 24-30.)

Judge Sweigert met this contention directly in his Memorandum of Decision:

The court further finds, however, that although the Bishop had contracted with the general contractor, Garing, for the razing of the old convent in accordance with his agreement, and although the building had been readied for razing by disconnection of the utilities, the razing operation had not been completed and had not even started to any appreciable extent at the time of the loss; that Allen, subcontractor for demolition purposes, had sent one man, Neal, into the old building on June 8, 1966, who merely loosened some plumbing, and that the fire loss occurred that night without any further progress toward demolition. Indeed, the contractor did not obtain a permit to demolish the building until June 9, 1966—the day after the fire.

We are of the opinion that neither the agreement with the Bishop nor the partial carrying out of that agreement amounted to an assignment or parting of the sisters' insurable interest

in the building. A mere permission granted to the Bishop for the eventual razing of the old building did not change the risk of loss. See, *Irwin v. Westchester*, 109 N.Y.S. 612 (1908); *Westchester v. Fitzpatrick*, 2 F.2d 651, 654 (3rd Cir. 1924); *Mackintosh v. Agricultural Fire Ins. Co.*, 150 Cal. 440, 89 Pac. 102 (1907); *Eagle v. Vermont Ins. Co.*, 213 Atl. (2d) 201 (Washington, 1965).

The fact that the sisters obtained a benefit under the plan of that agreement, e.g., the new convent in return for granting a mere permission to the Bishop for eventual razing of the old convent building, would be a collateral benefit to the sisters which the defendant company cannot urge in avoidance or reduction of its obligations under the policy. See, *Hughes v. The Potomac Ins. Co.*, 199 C.A.2d 239, 249-251, 18 Cal.Rptr. 650, 655-657 (1962). (CT p. 149, line 12 to 150, line 8.)

Directly on point on this issue is the *Wolf* case, cited by the Trial Court to demonstrate that this second collateral contract upon which appellant relies cannot relieve appellant of its obligation under its policy of fire insurance:

“It would appear that there are two broad lines of authority upon this question. What may be referred to as the ‘New York Rule’ is derived from *Foley v. Manufacturers’ Fire Ins. Co.*, 152 N. Y. 131, 46 N. E. 318 (Ct. of App. 1897) and a subsequent series of New York cases, especially *Alexandra Restaurant, Inc. v. New Hampshire Ins. Co.*, 272 App. Div. 346, 71 N. Y. S. 2d 515 (App. Div. 1947), aff’d. 297 N. Y. 858, 79 N. E. 2d 268 (Ct. of App. 1948). This rule is to the effect

that in the absence of any contractual agreement to the contrary, a fire insurance policy is a contract of indemnification, the premiums for which are computed according to the value of the property and the risk involved *without the knowledge of collateral remedies*, so that recovery on the policy will not be denied as long as the insured has a valuable insurable interest at the time of the casualty, even though there is an executory contract for the sale of the real property outstanding which is later consummated. A large majority of the courts in this country that have dealt with the question adhere to the New York Rule. *Dubin Paper Co. v. Insurance Co. of North America*, 361 Pa. 68, 63 A 2d 85 (Sup. Ct. 1949); *Vogel v. Northern Assurance Co.*, 219 F. 2d 409 (3 Cir. 1955); *First National Bank of Highland Park v. Boston Ins. Co.*, 17 Ill. 2d 147, 160 N. E. 2d 802 (Sup. Ct. 1959); *Edlin v. Security Insurance Co.*, 269 F. 2d 159 (7 Cir. 1959), *certiorari denied* 361 U.S. 932 (1960); *Board of Trustees Etc. v. Cream City Mutual Insurance Co.*, 255 Minn. 347, 96 N. W. 2d 690 (Sup. Ct. 1959); *Milwaukee Mechanics Ins. Co. v. Maples*, 37 Ala. App. 74, 66 So. 2d 159 (Ct. of App. 1953), *certiorari denied* 259 Ala. 189, 66 So. 2d 173 (Sup. Ct. 1953); *Springfield Fire and Marine Ins. Co. v. Boswell*, 167 So. 2d 780 (Fla. District Ct. of App. 1964); *Koppinger v. Implement Dealers Mutual Ins. Co.*, 122 N. W. 2d 134 (N. Dak. Sup. Ct. 1963); *Pink v. Smith*, 281 Mich. 107, 274 N.W. 727 (Sup. Ct. 1937); *Foster v. Equitable Mutual Fire Ins. Co.*, 2 Gray (68 Mass.) 216 (Sup. Jud. Ct. 1854)."

Wolf v. Home Insurance Company, 100 N.J. Super. 27, 241 A 2d 28.

3. *August 19, 1965*: Demolition subcontract between General Contractor Garing and Subcontractor Allen. (Defendant's Exhibit R, RT 201.)

Judge Zirpoli disposed of appellant's contention that the Sisters forfeited their insurable interest in the insured convent building at the time the demolition subcontract between Garing, the General Contractor, and Allen, the demolition subcontractor was signed in that part of his ruling cited in the foregoing section. (RT 62, lines 24-30.)

Judge Zirpoli's conclusion was reinforced by Judge Sweigert in his Memorandum of Opinion, also cited in the foregoing section. (CT 149, line 12 to CT 150, line 8.)

Both of these conclusions are impressively supported by the testimony of appellant's witness, Abdo Allen, the demolition subcontractor, when, on cross-examination, he stated as follows:

"Cross-examination

By Mr. Ford:

Q. Mr. Allen, I just have two questions, Mr. Castro mentioned permits for demolition. Did you, as a matter of fact, obtain permits from the City of Berkeley to demolish this building?

A. Yes, sir.

Q. Do you have them in your file?

The Court: Well, I should think, after what they said, they would have been glad to give him a permit to demolish it. So let's not worry about it.

Mr. Ford: Well, I want to get the date, Your Honor. It's most important. I would like to put that in evidence.

The Witness: Yes, I have the permits here.

Q. (Mr. Ford): What are those permits dated?

A. They are dated June the 9th.

Q. June the 9th of 1966?

A. Yes.

Q. And you didn't obtain the permit to demolish this building until the day *after the fire*, is that correct? (Emphasis added.)

A. If the fire was the 8th, we got the permits on the 9th.

Q. That's from the City of Berkeley?

A. Yes.

Q. Then in point of time, Mr. Allen, when did you actually begin your demolition, before or after the fire?

Mr. Castro: Object to that as argumentative, Your Honor.

The Court: Overruled, overruled.

A. What's that?

Q. (Mr. Ford): In point of time, Mr. Allen, when did you begin your demolition, before or after the fire?

A. Well, we couldn't start without permits. We got them on the 9th, so it would be after the fire.

Mr. Ford: Thank you, Mr. Allen." (RT p. 209, line 4 to p. 210, line 17.)

Thus, defendant's own witness testified that the demolition work did not begin until the day *after* the fire!

This factual circumstance is determinative of the legal issue attempted to be conjured by appellant.

4. *May 18, 1966: Recording of Notice of Completion of New Convent Building.* This event and the succeeding events cited by appellant in his Opening Brief (pp. 18, 19, 20, Appellant's Opening Brief) graphically demonstrate the misplaced emphasis of appellant in its analysis of this case. Rather than determine the rights as between the insurer—defendant and the insured—plaintiff as set forth in the insurance policy sued upon, appellant would rather look to, and depend upon, the collateral contracts of the insured with third persons. Not being satisfied with this irrelevant pursuit, appellant looks further to the contracts between various third parties, to which the insured—plaintiff—Sisters are not even a party! Appellant makes continued reference (Appellant's Opening Brief, pp. 5, 6, 19) to the "Master Plan" of the Sisters and the Bishop but neglects to point out that most of the "Master Plan" was wholly futuristic at the time of the fire loss, and most of this futuristic "Master Plan" had not been accomplished at the time of the fire. For appellant to attempt to rely upon such a futuristic, speculative, third party, irrelevant consideration in order to attempt to avoid liability on a clear, well-defined, definitive insurance contract is highly inconsistent.

POINT II

THE PREMISES RELIED UPON BY THE TRIAL COURT IN
RENDERING ITS DECISION WERE SOUND.

- A. "We are of the opinion that neither the agreement with the Bishop nor the partial carrying out of that agreement amounted to an assignment or parting of the sisters' insurable interest in the building." (Memorandum of Decision, CT 149, lines 24-27.)

This is the basic premise relied upon by the Trial Court.

Thus, the Court starts with the policy of fire insurance, really the crux of the entire case; starts with the insured convent building owned by the Sisters, and proceeds through the various stages during which appellant claims that the Sisters lost their insurable interest, and concludes that, at the moment of the fire, the Sisters had not parted with their insurable interest in the convent building.

Logically progressing in this manner, it is clear that the conclusion reached by the Trial Court is correct.

An examination of the fire insurance policy (Exhibit 12, RT 50, lines 1-5) reveals that the Company is quite definitive about the time at which coverage is granted and at which it terminates:

"... this Company, for the term of years specified above from inception date shown above At Noon (Standard Time) to expiration date shown At Noon (Standard Time) at location of the property involved." (Exhibit 12, cover page.)

Thus, Noon (Standard Time), in capital letters, is set by the Company, as the starting and stopping moment for coverage of the policy. It is definitive down to the minute.

Appellant would prefer to avoid such definition however, and rely upon any one of a number of possible moments at which the Sisters lost their insurable interest. In answer to these vagaries, Judge Zirpoli brought the insurance company back to the policy, Judge Sweigert brought the insurance company back to the policy, and the Court of Appeals must bring them to the same point.

In the first paragraph of his Memorandum of Decision, Judge Sweigert sets the stage by reference to the policy:

“This suit is brought under the diversity jurisdiction of this federal court to recover upon a policy of insurance issued December 1, 1961 (Ex. 12), covering the building at 2116 Jefferson Street, Berkeley, California (hereinafter referred to as the ‘old convent building’), a very old building constructed before the turn of the century for the term of 5 years, for a fire loss occurring on June 8, 1966.”

Memorandum of Decision, p. 1 (RT 147).

Thus, it is clear that the policy was still effective on the date of the fire, and that the terms of the policy determine the extent of liability. Appellant would prefer to depart from the policy; to consider extraneous matter; and to delve into third-party contracts to attempt to avoid liability. In spite of this attempt, appellant concludes his argument on this point with the statement:

“Insurable interest is to be determined according to the facts and circumstances obtaining *at the time of the fire*, not on the basis of what may or

may not happen at some time in the future.”
(Appellant’s Opening Brief, p. 27.)

With this conclusion, appellee wholeheartedly agrees!

Judge Sweigert in his opinion agreed also. He cites the case of *Wolf v. Home Insurance Company* and echoes the conclusion set forth by appellant above as follows:

“The basis of decision was that such collateral events should not determine the existence of the insured’s ‘loss’ within the meaning of the policy.”

The Court said:

“... The insurer is not being damaged by being compelled to pay the insured who is owner as of the date of the fire. Its premiums are assumed to represent the fair equivalent of the obligation it contracted to incur without knowledge of the existence of collateral remedies. *Board of Trustees, Etc. v. Cream City Mutual Ins. Co.*, 255 Minn. 347, 96 N.W. 2d 690, 696 (Sup. Ct. 1959). And the evil of the chance possibility of an ultimate collection by the vendor of the full purchase price from his vendee and also the insurance payment for the damage sustained does not outweigh the disruptions and harassments closely associated with delays in settlement of fire loss claims.” (Memorandum of Decision RT p. 518, line 25 to p. 159, line 4.)

Subsequent to the publication of the abbreviated opinion in U.S. Law Week, as cited in Judge Sweigert’s opinion, the cited case was reported at 100 N.J. Super. 27, 241 A. 2d 28. The New Jersey court ana-

lyzes the two broad lines of authority categorized as the "New York Rule" and the "Wisconsin Rule". The majority of jurisdictions, including California, as specifically set forth in the *Hughes* case, *supra*, have adopted the New York Rule. The Court characterizes that rule as follows:

"This rule is to the effect that in the absence of any contractual agreement to the contrary, a fire insurance policy is a contract of indemnification, the premiums for which are computed according to the value of the property and the risk involved without the knowledge of collateral remedies, so that recovery on the policy will not be denied as long as the insured has a valuable insurable interest at the time of the casualty." (*Wolf v. Home Insurance Co.*, 100 N.J. Super. 27, 241 A. 2d 28.)

Specifically cited in this case as adopting the Wisconsin rule is the case of *Smith v. Jim Dandy Market*, 172 F. 2d 616, heavily relied upon by appellants as authority in their brief. Since it is clear that California adopted the New York rule the attempted reliance upon the Wisconsin rule by appellant will avail them nought.

B. Time of the fire is time of the loss; not conditioned upon events after the fire.

Throughout that portion of appellant's brief dealing with the premises of the Trial Court's decision, appellant concerns itself with future speculative events and relies heavily upon the fact "that only a matter of days, if that much, remained before the building was totally demolished." (Appellant's Opening Brief, p. 28.)

Of course, this is not the point. The loss is determined as of the time of the fire, regardless of the fact that the insured building would be demolished moments later, days later, or weeks later. The insurance policy, as set forth above, it quite definitive, to the exact moment, Standard Time, when liability commences under the policy, and when it terminates. Appellant would terminate the coverage at some magic moment prior to the time of the fire loss, based upon the fact that the building would be demolished at some moment in time after the fire. This approach not only does violence to the contract but simply is not in accordance with the state of the law in California and in all of the jurisdictions adhering to the New York rule.

In this regard the *Wolf* case, *supra*, is again helpful since it clearly sets forth that what is meant by "time of the loss" is "time of the fire", and not some future time such as appellant contends.

"It is undisputed that plaintiffs held full legal title to the insured premises on the date of the fire. Did they also sustain a 'loss' as of that date? The statute and policy allow for a recovery up to the maximum coverage specified 'to the extent of the actual cash value of the property at the time of loss.' *The 'time of loss' can only intend the time of fire damage or destruction. If any other meaning were inferred, then the time for valuing the loss would be uncertain in every case. Defendant insurer offers this court no fixed standard for determining when a casualty loss is to be measured and argues only that here, after taking cognizance of collateral events not involving the*

insurer which came to be realized nearly five months after the fire, there was no loss. . . . This court similarly is of the view that the time of the fire is the common, usual and expected time for valuing 'loss'. It is axiomatic that the words used in an insurance policy will be construed in accordance with common usage. Jasion v. Preferred Accident Ins. Co., 113 N.J.L. 103 (E. & A. 1934); American Shops, Inc. v. Reliance Ins. Co. of Philadelphia, 26 N.J. Super. 145 (Cty. Ct. 1953)."

To give any meaning other than "time of fire" to the words "time of loss", moreover, results in totally contradictory interpretations to the word "loss" in the several sections of this fire insurance policy. The insurance contract provides that:

"The insured shall give immediate written notice to this Company of any *loss*, . . . and within sixty days after the *loss*, unless such time is extended in writing by this Company, the insured shall render to this Company a *proof of loss*, . . ." (Emphasis added.)

"On the facts *sub judice*, the insurance company maintains that if we look at the closing date between insureds and their vendee, nearly five months after the date of the fire, it becomes apparent that the plaintiffs have ultimately sustained no 'loss' within the intendment of the policy. If this is the time of determining 'loss', then, consistently, the 'immediate' written notice to the Company of any loss and the sixty day requirement for filing a proof of loss only come into play as of the closing date. *The defendant cannot have it both ways.* A contract of insurance must be con-

strued as a whole. *Herbert L. Farkas Co. v. N.Y. Fire Ins. Co.*, 5 N.J. 604, 610 (1950). While a party may plead inconsistent claims or defenses and may argue inconsistent principles of law, he cannot be heard to contend for two diametrically opposed sets of facts. *Flint Frozen Foods, Inc.*, *supra*, at p. 611; *In re Perrone*, 5 N.J. 514, 527 (1950). Certainly the only conceivable day meant by the terms of the policy after which notice of any loss must be given and proof of loss filed is the day on which the casualty occurred. Consistency dictates that the 'time of loss' for purposes of arriving at the 'actual cash value of the property' also be taken as the date of fire." *Wolf v. Home Insurance Co.*, 100 N.J. Super. 27, 241 A. 2d 28.

Appellant would disregard legal title to the real property and to the insured building. He concludes his argument on this point by saying:

"There is no room under that definition for exorbitant emphasis upon technicalities such as 'legal title' that bear no necessary relation to these realities.

In this case, the Sisters' legal title, if it did exist, was only marginal if at all relevant to their insurable interest. The testimony showed that the locus of 'title' to the building had no significance." (Appellant's Opening Brief, p. 23.)

On this point the *Wolf* case is again helpful because it compares the interest of a creditor in maintaining fire insurance with that of an owner, the holder of legal title, maintaining fire insurance and concludes:

“When the underlying nature of the respective interests being insured by a creditor and by an owner are examined, it becomes completely logical and consistent that a different rule should prevail in each instance. A creditor is interested only in having the debt or obligation owing to him assured. He seeks to have his *status* as creditor protected. An owner, on the other hand, already holds what our law considers to be the most complete type of interest and he wishes to insure his *physical property* rather than his status. In short, if a piece of property held as security burns down, the “loss” is not yet a proven fact because the creditor may still be able to pursue successfully his underlying obligation; *but if the same property held in outright ownership burns, the ‘loss’ is then complete because the ‘owner’ has nothing left to his ownership status except the ashes and rubble unless he can collect insurance that will enable him to rebuild or purchase some new property to evidence his ownership.*” *Wolf v. Home Insurance Company*, 100 N.J. Super. 27, 241 A. 2d 28.

C. Fire insurance indemnifies the owner and not simply the property.

Appellant attempts to diminish the “interest of the owner” by his argument suggesting that the collateral contracts divested the Sisters of their interest in the property. On this subject the *Wolf* case clearly defines the manner in which the fire-created depletion of the insured’s assets is measured.

“The point was made in *Tauriello v. Aetna Insurance Co.*, 14 N.J. Super. 530 at 532 (Law Div. 1951), that ‘a fire insurance policy is a contract

not to insure the property against fire but to insure the owner against loss by fire.' The highest court of Pennsylvania said the following in response to this assertion:

'This principle is correct but the appellants in order to sustain their position give it an erroneous interpretation. Of course, the policy does not 'insure a property against fire'; it does not purport to usurp the functions of Providence. But it does insure the owner of the covered property against the loss caused by the igneous destruction of his property and *that loss is measurable as soon as the destruction is complete. The loss the company contracts to remedy is the fire-created depletion of the insured's assets, and that is made up not by the erection of a duplicate of the building destroyed but by paying the insured its value in money. This liability the insuring companies cannot escape by anything any third parties may later do for the insured's benefit.*" *Dubin Paper Co. v. Insurance Co. of North America*, 361 Pa. 68, 63 A. 2d 85, 96 (Sup. Ct. 1949.) (Emphasis added.)

Earlier in the same opinion, the Court declared (63 A. 2d at 92):

"The destruction of a building by fire may conceivably bring many benefits to the owner and whatever these may be, the insurance company cannot participate in them."

Wolf v. Home Insurance Co., 100 N.J. Super. 27, 241 A. 2d 28.

POINT III**RULE 56(d), FEDERAL RULES OF CIVIL PROCEDURE PROVIDES FOR AN ORDER SPECIFYING FACTS NOT IN CONTROVERSY.**

Appellant complains that, pursuant to Motion for Summary Judgment, the District Court entered its Summary Adjudication of Facts Not in Controversy and Duly Established (CT 61.)

By reference to the analysis submitted by plaintiff in the Declaration Supporting the Motion for Summary Judgment, (CT 34, 35, 36) it is clear that each of the facts set forth were admitted by defendant in its pleadings prior to the date of the hearing on this motion. Additionally, defendant filed extensive Memorandum of Points and Authorities (CT 42-49) and further extensive Objections to Proposed Findings (CT 56-59) before the Court entered its own form of "Summary Adjudication of Facts Not in Controversy and Duly Established" (CT 61-63), subsequently modified by Order Modifying Summary Adjudication (CT 83-84) determined after Motion to Vacate pursuant to Rule 60(B), Federal Rules of Civil Procedure, filed by defendant (CT 65), supported by further extensive argument by defendant (CT 67-76).

There is no question that the trial court is authorized to enter such an order.

"(d) Case Not Fully Adjudicated on Motion . . . It shall thereupon make an order specifying the facts that appear without substantial controversy . . ." Federal Rule of Civil Procedure 56(d).

This is exactly what the Trial Court did. It made its determination directly from the admissions of defendant in its own pleadings.

Following this determination, Judge Peckham entered the Final Pretrial Conference—Plan of Trial Order (CT 85-89) incorporating the “Facts Not in Controversy” again over the strenuous argument of defendant (CT 90-105) and the matter proceeded to trial.

At the trial before Judge Sweigert, extensive evidence was admitted, presented by defendant, and over the continuing objection of plaintiff, on each of the “Facts Not in Controversy” found by Judge Zirpoli and affirmed by Judge Peckham. In his Memorandum of Decision, Judge Sweigert specifically finds on each of the issues presented and cites the evidence elicited at the trial supporting these findings. Thus, in spite of the adjudications on the “Facts Not in Controversy” defendant did proceed, at the trial, to re-litigate these same issues. He was allowed great latitude by the trial judge, and again, his contentions were rejected, for the third time. For defendant to make the assertion, for the fourth time on appeal that:

“Defendant understandably prepared and presented its case in acquiescence to this order” (Appellant’s Opening Brief, p. 32)

is purely and simply a misstatement of the fact. A brief reference to the trial transcript confirms this:

“Mr. Ford: Pardon me, Your Honor. I will object to any questions based on this document, for the reason that it is wholly irrelevant in this proceeding. It goes to an issue that is not before this Court. All issues with respect to this document have been determined previously by the

summary adjudication of facts by Judge Zirpoli. It has been determined that the agreement between the Bishop and the Sisters, the one that we are now attempting to introduce, had no bearing, and there's a specific finding in Judge Zirpoli's order that it had no effect upon the insurable interest of the Sisters. Therefore I would object to any questions about it, on the basis, on the ground of relevancy, Your Honor.

The Court: Overruled. Go ahead." (RT p. 31, line 23 to p. 32, line 12.)

“Mr. Ford: Pardon me, Your Honor. May I cite to the Court—this goes to my basic objection on the contract between the Sisters and the Bishop—specifically to my objection to this agreement with the auction gallery, the case of Hughes vs.—

The Court: No, I don't want to hear any law now. Let's get the facts in." (RT p. 35, lines 7-13.)

Thereafter, each objection by plaintiff was overruled and defendant proceeded to fully present all evidence on the matters embraced in the Summary Adjudication and in the Pretrial Order. For defendant to now contend that it “understandably prepared and presented its case in acquiescence to this order” is clearly controverted by the record.

In interpreting Rule 56, the commentators and courts have uniformly held that the procedures therein greatly expedite and clarify litigation:

“To expedite litigation, Rule 56 permits partial summary judgments. . . . In addition, Rule 56(d) provides that at the hearing on the motion,

the court has power to examine the pleadings and evidence before it and to interrogate counsel. The court "shall if practicable" ascertain what material facts exist without substantial controversy and what material facts are actually and in good faith controverted. It should then make an order specifying the facts that appear without substantial controversy, including the extent to which the amount of damages or other relief is not in controversy, and directing such further proceedings as are just."

Federal Civil Practice, CEB pp. 373-374, §4.36.

"When a court enters a partial, interlocutory summary adjudication, pursuant to subdivision (d) of this rule providing for an order specifying facts that appear without substantial controversy on a motion for summary judgment, the court does not render a final judgment which is appealable, but only an order as to uncontroverted facts, which, being interlocutory, is subject to revision or modification." *E. I. Du Pont De Nemours & Co. v. U. S. Camo Corp.*, D.C. Mo. 1956, 19 F.R.D. 495.

"Partial summary judgment is merely a determination before trial that certain issues shall be deemed established in advance of the trial so as to avoid useless trial of facts and issues over which there is no real controversy." *Luria Steel & Trading Corp. v. Ford*, D.C. Neb. 1949, 9 F.R.D. 479, affirmed 192 F. 2d 880."

On this basis, it is clear that no error was committed either by Judge Zirpoli in his initial findings of uncontroverted facts, by Judge Peckham on the Pre-trial Order, or by Judge Sweigert in the trial or in his Memorandum of Decision.

POINT IV

**THE TRIAL COURT ADOPTED THE "BROAD EVIDENCE RULE"
IN DETERMINING "ACTUAL CASH VALUE."**

Appellant's entire argument advocating the adoption of the "broad evidence rule" (Appellant's Opening Brief, pp. 33-57) must fall upon deaf ears in the Court of Appeals since the trial court *did* adopt the broad evidence rule in determining damages in this case. How does appellant otherwise explain the deduction of \$52,000 from actual cash value made by the Court?

"Allowance for Removal of Certain Fixtures

It appears from the evidence (testimony of witness Gilbertson) that some fixtures had been removed by the sisters from the old building before the fire—some stained glass, some plumbing fixtures, some electric panels and fixtures. Neither witness Hunt, Newkirk nor Saleme took these removals into consideration in their estimates because, apparently, they did not know about them. The insurance company should not be required to absorb the replacement cost of these items. The only evidence in the record as to their replacement cost is the testimony of Horton—\$52,000—together with some documentary evidence (Ex. C) that these items brought only about \$4,000 at an auction sale a few days before the fire. The court finds that a reasonable allowance for the replacement cost of these items (which would obviously be greater than their resale value) is \$52,000.

For the reasons herein set forth the court finds that the 'actual cash value' of the building at the time of the loss, within the meaning of the policy, was at least \$226,000, less \$52,000 (the

cost of replacing some fixtures removed by the sisters before the fire), i.e., \$174,000, and the court concludes that plaintiffs are entitled to judgment in that amount—\$174,000.” (CT p. 159, lines 5-27.)

Surely appellant does not contend that this \$52,000 allowance is encompassed within the replacement cost less depreciation formula. Appellant cannot be considering this factor when it states:

“But in considering the evidence and arriving at judgment, the court relied *exclusively* on evidence of the building replacement cost (less depreciation) to determine actual cash value and formulated its rule of law accordingly.” (Appellant’s Opening Brief, p. 40.)

Whence, then, the \$52,000? How does appellant explain this reduction within the confines of the rule it suggests the trial court adopted? It cannot.

Rather than labor this point, let us view the actual “broad evidence test” as it is interpreted in the treatises and review the evidence presented at trial in light of the findings expressed in the Memorandum of Decision.

(a) The Broad Evidence Test.

Appellant cites the “broad evidence test” at page 37 of its Opening Brief but then fails to elaborate upon it to show that the trial court followed each of the dictates of the test in determining the “actual cash value” of the insured building at the time of the loss.

Appellee, on the other hand, presented a comprehensive analysis of the various methods of determin-

ing "actual cash value" in its Trial Memorandum (CT 106), and at page 122, set forth the following:

"§5 Broad evidence rule.

Although for some time almost all courts applied either the market value or the reproduction or replacement value test in determining 'actual cash value', there has been in recent years a tendency on the part of some courts to look beyond these criteria in order that more complete indemnity might be effectuated. These courts have held, in essence, that any evidence logically tending to the formation of a correct estimate of the value of the destroyed or damaged property might be considered by the trier of facts in determining 'actual cash value' at the time of loss. Thus, in applying this rule, which might be denominated the broad evidence rule, the courts have *not abandoned consideration of either market or reproduction or replacement values in arriving at 'actual cash value'*, but view them merely as guides in making that determination, rather than shackles compelling strict adherence thereto." (CT p. 122, line 32 to p. 123, line 9—quoting from 61 A.L.R. 2d 711, an annotation dealing with the proper method of determining "actual cash value".)

Recognizing then, that market and reproduction or replacement value have not been abandoned by the courts, but rather that they are guidelines "in making that determination, rather than 'shackles compelling strict adherence thereto', let us investigate the evidence presented by both sides on the question of damages."

(b) Plaintiff's Evidence on Damages.

1. Mother Mary Thaddea, assistant to Mother General, Sisters of the Presentation:

(Mr. Ford) "Q. I see. And do you now, Mother, have an opinion of your own, as the representative of the Sisters of the Presentation, of the value of the insured building at the time of the loss?

A. Yes, I have a very strong opinion on it. . . .

The Court: Just what you think the value is and your reasons later.

A. (Continuing): The amount, \$210,000.

The Court: Fine.

(Mr. Ford): Q. What do you base that opinion on?

A. I base that opinion on the letter from the insurance company itself." (RT p. 27, line 6 to p. 28, line 5.)

Thus, proof of value from the opinion of a qualified representative of the owner-insured.

2. William Hunt, Real Estate Appraiser:

"(Mr. Ford): Q. Mr. Hunt, in order to give your opinion of actual cash value, what method did you use? What recognized appraisal method?

A. The recognized appraisal method I used, which is common in the appraisal profession, is the summation value. In other words, you have to start from scratch, what this building would cost to reproduce it at the time you make your appraisal.

Q. Are there other methods to be used in determining actual cash value?

A. There's two other methods that's common. One is the income approach and the other is the comparative approach.

Q. Were those applicable in this case?

A. No, sir.

Q. Why not?

A. Well, first of all, this is not an income piece of property. So I washed that out. Secondly, the comparable approach or the market approach—this is hardly any—the comparative approach, you use by comparing it with sales of other like properties or types of properties in the neighborhood or possibly within a fair vicinity. That's like the property, the sales on those properties. No, I know of no sales and I couldn't find any sales of like properties in the Bay Area, like this subject property. Therefore, I didn't use the comparative or market data approach.

Q. So what approach did you use, Mr. Hunt?

A. The only one is the summation approach.

Q. And would you describe for the Court the manner in which you go about the summation approach to determine actual cash value?

A. Well, we gather, figure out the square foot area of the buildings. We apply a cost factor to that to reproduce it as of today, we will say, or the time I make my appraisal.

Q. Where did you get that cost factor?

A. I get that cost from various services, like Marshall Stevens, from my own experience with the Veterans Administration, FHA and various associations with cost analyses, people who are working with it all the time. Then I have my personal opinion by reason of comparison of properties. So I take the one that's closest in my opinion, which I think will fit the case.

Q. And using that approach to determine actual cash value, did you determine the replacement value of the building?

A. Yes I did.

Q. What is your opinion of the replacement value of the building, using the summation approach?

A. In 1966, that year of the fire, my opinion, to replace that building would amount to \$456,000.

Q. Now, are there any other factors that you must consider to determine actual cash value as compared with your replacement cost?

A. Yes. I observe the building in its condition and I study out how it appears to be physically. Maybe some obsolescence and so forth. And I add the two together, physical obsolescence in my opinion, and so I depreciate this another 50 percent.

Q. 50 percent depreciation?

A. Yes.

Q. Now, applying that depreciation, what figure do you arrive at?

A. Well, including some other values, like, there's a lot of cement flat work there, there, there was fences and landscaping. Adding those two on, which amounted to a couple of thousand, in my opinion, I then arrived at a figure of \$230,000.

Q. And the \$230,000 figure is your estimate of what?

A. The fair market value or the depreciated value or the actual cash value as of the time of my appraisal.

Q. As of the time of the fire?

A. That's right, yes, at the time of the fire.

Q. All right. Now, Mr. Hunt, were you able to cross-check your opinion, arrived at through

the summation approach, by any other methods?

A. Yes, I was, and I did.

Q. What did you do?

A. Well, I received a letter written by the Royal Globe Insurance, sent to the Sisters, or a man named Frank Costello, as to their opinion in July 26th, 1963, what they thought the business was worth.

Q. Now, were you able to use that letter in any way to cross-check your opinion?

A. That's right.

Q. What did you do, Mr. Hunt?

A. Well, I took their figures, as I have the letter in front of me, and this was made in 1963, and I updated, upgraded, we will say, to 1966, which we have to do in the procedure of appraisal.

Q. How did you do that, Mr. Hunt, when you updated it?

A. Upgraded, I should say. Upgraded, bringing it up to date. Well, I sort of took their figures here and I relied that they could be right. I did not lean too much to it, but I took their own figures and then I come to replacement cost, which they use the word 'replacement cost' on this letter, \$330,000. Well, from all services we have, the average increase in that number of years runs around three, $3\frac{1}{2}$ percent. But I just took $2\frac{1}{2}$ percent. So I multiplied $2\frac{1}{2}$ percent by 3, which was $7\frac{1}{2}$ percent, which is '63 to '66. So I increased their replacement cost by $7\frac{1}{2}$ percent.

They have insurance exclusions, which average $3\frac{1}{2}$ percent. I took their own procedure, and I subtracted $3\frac{1}{2}$ percent for insurance exclusions.

Then they put down 35 percent depreciation. I took that 35 percent depreciation. So I sub-

tracted the total that I have arrived at by 35 percent, and so on down the line.

On their figures here, their totals amount to about \$220,000, which they thought it was worth at that time. But by upgrading it, the biggest depreciation they took off was only 35 percent. I upgraded it and then my opinion comes to a certain amount of money. But I was a little stiffer on depreciation than they were. But I still come up to \$230,000.

Q. So by checking your opinion, arrived at through the summation approach, against an upgrading of the insurance company's approach, what conclusion did you reach?

A. \$230,000." (RT p. 64, line 11 to p. 69, line 11.)

Thus, this expert real estate appraiser gave his opinion based upon the summation approach cross-checked against the opinion of the defendant insurance company updated to the date of the fire loss. A synopsis of the method by which he reached his opinion was introduced into evidence. (Plaintiff's Exhibit 22; RT 93, line 19.)

3. Kenneth Newkirk, construction cost analyst:

"Q. And what was the purpose of the property damage appraisal?

A. To establish the replacement value of the property based on the cost at the time of the fire.

Q. And what do you mean by replacement value or replacement approach to determining actual cash value?

A. The cost it would take to duplicate the buildings in their conditions immediately prior to the time they were damaged, or to the time it was asked that the appraisal be made.

Q. All right, and how do you go about determining that cost, Mr. Newkirk?

A. By establishing the features of the building, the physical features, and then making an actual count of the component parts of the building. That includes studs, nails, eaves, gutters, all details of the building. Enumerating those in quantity, totalling those quantities, transferring those quantities to an estimate sheet and applying the unit costs of the materials and labor applicable at the time, the chronological time that it was asked that the appraisal be made. Thereby you arrive at a total cost of replacement. This is the routine way in which any construction estimate is prepared.

Q. All right, now, I refer you to Plaintiff's Exhibit No. 20 for identification, which is before you. Do those six sheets comprise the floor plan that you prepared as the first step in your approach to the replacement cost?

A. Yes.

Q. And would you tell the court how you were able to reconstruct the floor plan of the building after the fire, after the fact?

A. Well, the initial step was to contact Mr. Saleme, who, along with an aide, took a great many pictures prior to or during demolition, and determine from him all the information that I could of the features of the building.

Q. What's the next thing that you did, Mr. Newkirk?

A. Next thing that I did was to conduct a great many conferences with the Sisters who had actually lived in the buildings, supervised them, and were thoroughly cognizant and familiar with all the details.

Q. How many conferences would you say you had with the Sisters who had lived in the building?

A. As I recall, there were six conferences.

Q. And did you use the photographs at that time also?

A. I used Mr. Saleme's photographs, and then the ladies produced a great many more photographs and were able to comment extensively on the features in the photographs. And from their comments and information, I prepared tentative sketches, which I then took to them for their comments and corrections. The sketches were revised, brought down to a closer state of refinement, at which time I again took the sketches back to them, compared them with the pictures that they had, and finally produced the drawing shown here, which the ladies have assured me are extremely accurate representations, even to the exact scale of the two structures.

Q. How much time would you say you spent in conference with the Sisters in order to produce these plans, Mr. Newkirk?

A. The conferences themselves occupied perhaps, oh, as long as 24 to 30 hours. The work in preparation of the plans occupied perhaps as much as 60 hours.

Q. And at this present time you would say that that is an accurate representation of the convent as it stood on the day before the fire?

A. I am thoroughly convinced that it is.

Q. And this floor plan is an accurate summary or schedule of the convent as it appeared on the day before the fire?

A. Yes.

Mr. Ford: Offer Plaintiff's Exhibit 20 for identification into evidence, Your Honor.

The Court: All right.

(Plaintiff's Exhibit 20 for identification received in evidence.)

Q. Mr. Ford: Now, Mr. Newkirk, having produced the plans, what is your next step in the process of determining the reproduction cost?

A. To make what is known as a quantity survey, which is of course the determination of the quantity of materials used in construction of the building.

Q. Now I will show you Plaintiff's Exhibit No. 21 for identification, a series of six pages. Is that the quantity survey or cost analysis that you made from the building plans?

A. This is not the quantity survey; this is the recapitulation of the quantity survey, and this constitutes the estimate, the cost estimate.

Q. All right, referring to Plaintiff's Exhibit 21 for identification, would you tell the Court how you went about preparing that analysis?

A. From the quantity survey, the quantities of materials which were taken off, in great detail, were transferred to the estimate sheet and listed hereon, and costs which were prevalent in 1966 were applied to these totals to arrive at the cost of the component parts and the installation of them and the incorporation into the structure. Those totals were then grand totalled and the various payroll taxes, sales tax overhead and profit features added, to arrive at the reproduction cost of the building.

Q. All right, now, as a result of that approach, Mr. Newkirk, do you now have an opinion of the replacement cost of the insured convent buildings?

A. I do.

Q. What is your opinion?

A. The cost to replace the buildings, from the tops of the foundation up, the foundations were not included, is \$439,675.56.

Q. Now, that replacement cost would give us a brand-new building, is that right?

A. Yes.

Q. Now, is there any other factor that you must take into consideration to reduce the replacement cost to actual cash value?

A. Yes, physical depreciation.

Q. And did you apply any percentage for physical depreciation?

A. 50 percent.

Q. 50 percent. As a result of the application of that factor, do you have an opinion as to the actual cash value of the building as of the date of the fire?

A. \$219,837.78." (RT p. 101, line 14 to p. 106, line 18.)

Thus, this expert cost analyst gave his opinion based upon a quantity survey approach to "actual cash value".

After cross-examination, the relevance of the "broad evidence rule" was graphically and succinctly pointed out by this expert:

"Redirect Examination

By Mr. Ford:

Q. Mr. Newkirk, were all of the factors Mr. Castro mentioned taken into consideration at arriving at your depreciation amount after having established your replacement cost?

A. You mean from the standpoint of function and economic obsolescence as well as the physical depreciation?

Q. Yes.

A. Yes, those are intangibles upon which I could place no percentage, but which are a real factor.

Q. A real factor in the depreciation?

A. Yes.

Mr. Ford: Thank you, Mr. Newkirk." (RT p. 111, lines 8-20.)

Thus, all of the factors that appellant contends should be considered under the broad evidence rule were so considered in reaching a determination of proper depreciation.

4. William Saleme—repair contractor:

“Q. Mr. Ford: Now, Mr. Saleme, after making the inspection of the damaged premises and taking the photographs, did you at my request prepare an estimate of the cost of repair of the building?

A. Yes.

Q. Would you refer to Plaintiff's Exhibit 13 for identification? Does that correctly set forth your estimate to repair the building?

A. Yes.

Q. And what is your estimate of repair to the building, Mr. Saleme?

A. \$237,552.

Q. And how did you break that down in order to arrive at that figure?

A. Well, from my visual inspection, we first of all broke it down by square footage on each floor of each building, and then we arrived at a percentage of damage on each floor, and then arrived at a square footage cost for reconstruction, and applied the factors and arrived at the price.

Q. And after the application of all of the factors in arriving at the price, what was your cost to repair that damaged building?

A. \$237,552." (RT p. 117, line 10 to p. 118, line 8.)

Thus, the expert repair contractor testified to repair cost, providing another of the "facts and circumstances" relevant under the "broad evidence rule" cited by appellant. (Appellant's Opening Brief, p. 37.)

This cost of repair is "more of a limitation on the insurer's liability than a substantive measure of damages" (CT p. 152, lines 28-29), but, within the context of the "broad evidence rule" it is abundantly clear that the testimony of the witness Saleme provided the Court with additional factors other than "replacement value less depreciation—period". (Appellant's Opening Brief, p. 40.) In citing this statement of the Court, out of context with the Memorandum of Opinion, appellant attempts to throw the method of determining "actual cash value" completely out of focus.

5. Elmer Madsen—Royal Globe Insurance Company Special Representative—Fire Protection Department (RT p. 126, lines 14-17):

"Q. All right. Were you aware, in July of '63 when you wrote that letter, that the property that you were inspecting was then the subject of a standard California fire insurance policy in the amount of \$210,000?

A. I knew there was a policy, yes.

Q. You knew there was a policy. Did you know the amount?

A. Yes.

Q. And you were not employed by any separate independent underwriting board or appraisal firm; you were employed by Royal Globe Insurance is that correct?

A. Yes.

Q. Within the course and scope of your employment, you made this evaluation for the Sisters?

A. No, I made an inspection.

Q. You made an inspection?

A. To see if the building was the same as it had been when the original evaluation was made in 1956.

Q. So prior . . .

Pardon me, I'm sorry. Were you finished?

A. I brought the values up to date. I did not make a valuation at that time.

Q. What were the values in 1956?

A. Replacement cost was \$290,000.

Q. What was the date in 1956?

The Court: What was it in 1956, two what?

Q. Mr. Ford: \$290,000, Mr. Madsen?

A. Was the replacement cost, yes.

Q. What was the date in 1956?

A. November 28th.

Q. Did you make that appraisal?

A. No, sir.

Q. So between that date and your appraisal in 1963, it was your opinion that the value of, the insurable value of the building decreased, is that correct?

A. No, this was, the \$290,000 was the replacement cost.

Q. Oh, I see, I see. All right, what was your replacement cost in 1963?

A. \$330,600.

The Court: Three hundred what?

The Witness: \$330,600.

Q. Mr. Ford: \$330,600?

A. Yes.

Q. Replacement cost?

A. Yes, sir.

Q. What was your opinion of the 100 percent insurable value as of July the 26th, 1963, as set forth in your letter?

A. \$207,370.

The Court: Two hundred seven—

The Witness: \$207,370.

Q. Mr. Ford: \$207,370?

A. Yes." (R/T p. 127, line 22 to p. 130, line 3.)

(c) Defendant's Evidence on Damages.

Appellant is concerned that the evidence presented by their witnesses was not considered by the Court:

"Conversely, the Court disregarded the testimony of defendant's appraiser concerning the adverse effect on the building's value of the substantial costs of conforming it to the Code, on the ground that 'the witness did not even consider the cost of replacement of the building to its condition as it stood just before the fire' R 154" (Appellant's Opening Brief, p. 40)

Let us inquire into how these witnesses fared on qualifying their opinions and testimony:

1. Paul Shobring—Building Inspector, City of Berkeley:

After testifying that he delivered notices of discrepancies to the Sisters, Mr. Shobring was asked on cross-examination:

“Cross-Examination

By Mr. Ford:

Q. Mr. Shobring, I will show you Defendant's Exhibit N in evidence, which is the form of permit of occupancy of the City of Berkeley.

A. Yes.

Q. It is your obligation to issue that form of permit of occupancy, is that correct?

A. That's correct.

Q. Did you issue such a permit of occupancy to the Sisters of the Presentation in 1961?

A. Yes, as I—about the same date.

Q. Did you issue such a permit of occupancy in 1962?

A. Yes.

Q. Did you issue such a permit of occupancy in 1963?

A. Yes.

Q. Pardon me?

A. Yes.

Q. Yes, you did?

A. Yes, I did.

Q. Did you issue such a permit of occupancy in 1964?

A. Yes.

Q. I am sorry, I couldn't hear you.

A. Yes.

Q. Did you issue such a permit of occupancy in 1965?

A. Yes.

Q. Did you issue such a permit of occupancy in 1966?

A. Yes.

Mr. Ford: No other questions, Mr. Shobring.

The Witness: No, excuse me on that last question.

Mr. Ford: Explain it if you like.

The Court: The last question was, 'Did you issue such a permit of occupancy in 1966?' Did you?

The Witness: Was that the year of the fire?

Q. Mr. Ford: Yes, it was.

A. No.

Q. You hadn't as yet made your inspection in 1966?

A. No.

Mr. Ford: Thank you, Mr. Shobring. No other questions, your Honor.

The Court: All right, fine. Thank you, sir."
(RT p. 193, line 13 to p. 195, line 11.)

Thus, the official representative of the City of Berkeley testified that, regardless of the notices, each year, year after year, he continued to issue occupancy permits. Of what value then is his testimony about the discrepancies? Appellant spends two pages (Appellant's Opening Brief, pp. 8-9) reviewing this testimony but not one line to the complete destruction of the testimony on cross-examination.

2. John M. Gilbertson—Insurance Estimator:

“Recross-Examination

By Mr. Ford:

Q. Mr. Gilbertson, I note from your schedule that you are with W. A. Rose and Company, is that correct?

A. Correct.

Q. What's your capacity with W. A. Rose and Company?

A. I am a member of the corporation and also an estimator.

Q. And insurance work is your specialty, is that correct?

A. That is correct.

Q. Therefore you prepared this estimate in accordance with and pursuant to the provisions of the Standard Fire Insurance Policy that's involved in this action, is that correct?

A. No.

Q. Oh, you did not?

A. No.

The Court: Now, that may go into evidence. This Exhibit B-2, your breakdown which counsel has, may go into evidence as a summary and schedule, is that correct?

Mr. Castro: Yes.

Mr. Ford: Yes, Your Honor. No objection.

(Defendant's Exhibit B-2 received into evidence.)

The Court: All right.

Now, go ahead.

Mr. Ford: Q. So this estimate that you have presented to the Court has no reference whatsoever to the Fire Insurance Policy that's involved in this action, is that correct?

A. Directly, no. I was asked to prepare an estimate as far as I could determine as to the cost of bringing that building up to code requirements before the fire.

Q. Before the fire?

A. Before the fire.

Q. Now, how does that relate to the provisions of the policy that provide 'but not exceeding the amount which it would cost to replace or repair the property with material of like kind and quality within a reasonable time after such loss'?

A. I have nothing to do insofar as interpreting insurance policy is concerned.

Q. And you didn't prepare anything to show in accordance with the policy the cost to repair or replace with materials of like kind and quality after the loss, did you?

A. That is correct.

Q. This refers to before the loss, doesn't it?

A. Yes, yes.

Q. And it doesn't refer to this policy or this building in this case, does it?

A. It refers to the building.

Q. Before the loss?

A. Yes.

Q. Not after the loss?

A. I was—it was my understanding that His Honor asked that—

The Court: Listen, I didn't ask anything. Just what do you want to find out?

The Witness: I don't get what he is driving at, Your Honor.

The Court: Well, if you just make short questions and factual questions we will get answers.

Mr. Ford: Q. This estimate contemplates repair before the loss, is that correct?

The Court: No, no. As I understand it counsel, your estimate that you have given here is an estimate of what it would cost to bring this building into conformity with the Berkeley Code requirements if done before the fire.

The Witness: That is correct, Your Honor.

The Court: Isn't that it?

Mr. Ford: That's correct, Your Honor.

The Court: Well, why get it all balled up then?

Mr. Ford: Q. It refers in no way to repairing the building after the loss, is that correct?

A. That is correct.

Mr. Ford: No other questions.

The Court: In other words, you didn't attempt to figure merely the cost of replacing the building after the loss?

The Witness: That is correct, Your Honor.

The Court: To the condition it was before the fire, you did not figure that?

The Witness: That is correct, Your Honor.

The Court: All right.

Mr. Ford: No other questions, Your Honor."
(RT p. 434, line 10 to p. 438, line 4.)

Thus, Mr. Gilbertson, in reply to the Court's questions admitted that his estimate bore no relation whatsoever to "actual cash value", the measure of damages set forth in the insurance policy. His testimony refers merely to cost to conform the building to code prior to the fire; it had nothing whatsoever to do with replacement cost, reproduction cost, depreciation, or ultimately, "actual cash value", the measure set forth in the policy and applicable under the law.

3. George A. Horton—Real Estate Broker and Appraiser:

"Recross Examination"

By Mr. Ford:

Q. Mr. Horton, you testified you were a real estate broker?

A. I have a broker's license, yes, sir.

Q. Are you a building contractor also?

A. No, sir.

Q. May I see your breakdown for the building items that you testified would require \$121,000?

The Court: I want all of the testimony of any witness who gives an opinion of this kind to be reflected in some kind of a schedule or summary. And I take it this is it, is it, sir?

The Witness: I have a better summary given by Mr. Gilbertson who is a contractor.

The Court: I am talking about yours. You are the man who is testifying. Is this your calculation?

The Witness: Yes, sir.

The Court: All right. Mark it as an exhibit.

And this correctly reflects the calculations you have testified to?

The Witness: Yes, sir.

The Court: All right.

The Clerk: It's Plaintiff's Exhibit 24 for identification.

Mr. Ford: It can go right into evidence as far as I am concerned, Your Honor.

The Court: All right. No objection.

The Clerk: That's Defendant's Exhibit A-2.

Mr. Ford: Yes, Defendant's.

(Calculations of Mr. Horton marked for identification as Defendant's Exhibit A-2 and received into evidence.)

Mr. Ford: Q. Now, Mr. Horton, in your experience as a real estate broker, how many roofs have you fixed to the extent of \$10,000?

How much experience have you had in fixing roofs to the extent of \$10,000 improvement?

A. Sir, I don't repair roofs.

Q. You don't repair roofs?

A. No.

Q. All right.

A. I am a real estate appraiser and a realtor and I estimate these things, and in order to

estimate them I discuss the matter with qualified persons who are capable of giving me what I consider sound advice on certain costs.

Q. So then this isn't your estimate, this is someone else's estimate?

A. I was in a consultation with a contractor when that was prepared.

Q. So this is not your estimate, it's someone else's estimate?

A. Not in total, some of the figures are mine and some are the contractors.

The Court: Well, your business is to buy and sell real estate and also incidentally to give appraisals on the value of a piece of real estate, isn't that right?

The Witness: Generally speaking at this time Your Honor, my business is real estate appraising, and I do incidental brokerage occasionally.

Mr. Ford: Q. You don't estimate the cost to repair buildings as a profession, do you, Mr. Horton?

A. Not the cost to repair buildings, no, sir.

Mr. Ford: I don't have any other questions.

The Court: All right. Fine. Thank you, sir."
(RT p. 424, line 13 to 427, line 10.)

Thus, Mr. Horton revealed that he was not even qualified to testify on matters that he was presenting to the Court, but rather, that he was using someone else's opinion. Little wonder that the trial Court "disregarded the testimony of defendant's appraiser". (Appellant's Opening Brief p. 40.) How is the trial Court to give credence to any testimony that the witness admits he is unqualified to give?

(d) Conclusion from Comparison of Testimony by Plaintiff and Defendant.

The only conclusion that can be drawn from a comparison of the testimony of Defendant's witnesses and Plaintiff's witnesses is that the Court accepted the testimony of Plaintiff's witnesses as modified by that of Defendant's witness Horton. The Memorandum of Decision clearly reflects this throughout and clearly defines that the Court considered many factors other than simply replacement cost-depreciation, period. If that were the sole criteria, the Court could not have deducted the sum of \$52,000.00 for removal of fixtures and could not have relied upon the testimony of Defendant's witness Horton, the only one to give this estimate.

Based on all of the above, it is clear that the Court considered all relevant factors in making its determination of "actual cash value". Rather than rejecting the "broad evidence rule", the Court permitted the widest range of testimony, took into consideration the following factors:

- (1) The age of the building: "a very old building constructed before the turn of the century". (Memorandum of Decision, RT p. 147, lines 5-6.)
- (2) The Agreement between the Bishop and the sisters and performance thereof. (Memorandum of Decision, RT p. 148, line 25 to 149, line 4).
- (3) The Contract between the Bishop and the general contractor Garing. (Memorandum of Decision, RT p. 149, lines 11-23).

- (4) Vacancy of the building and increased hazard. (Memorandum of Decision RT p. 150, line 34 to p. 151, line 16.)
- (5) Notices delivered to the sisters by defendant's witness Shobring. (Memorandum of Decision, RT p. 151, line 26 to 152, line 1.)
- (6) Opinions of Plaintiff's experts (Memorandum of Decision, RT p. 153, lines 11-27.)
- (7) Opinions of Defendant's experts (Memorandum of Decision RT p. 153, line 30 to 154, line 9.
- (8) Conformity with Berkeley building code (Memorandum of Decision, RT p. 154, lines 10-16.)
- (9) Removal of Fixtures. (Memorandum of Decision RT p. 159, lines 5-20.)

In view of the consideration given to each of these factors as outlined in the Memorandum of Decision it is rather farfetched of Appellant to contend that the Court did not take into consideration any other factors than replacement cost-depreciation, period. The decision clearly demonstrates the wide range of consideration indulged by the trial Court and clearly demonstrates, by the \$52,000 reduction, that the Court was not bound by the shackles of the replacement cost test alone. Call it by any other name, or call it by no name at all, this was the "broad evidence rule" in actual operation.

POINT V

**APPELLANT'S CONTENTION OF SUSPENSION OF INSURANCE
BASED UPON INCREASED HAZARD IS FULLY ANSWERED
IN THE MEMORANDUM OF DECISION.**

On this point, the trial Court completely analyzed the facts, as found from the evidence, as applied to the law, and said:

Increased Hazard Issue

Defendant, relying on the "Permits and Agreements Clause" (Para. 19) and the "Conditions Suspending or Restricting Insurance" clause (lines 28-31) contends in effect that the sisters increased the hazard of loss by change of the use and occupancy of the building.

There is no express provision in the policy requiring that the building be used for any specifically stated purpose but Paragraph 19 provides that permission is granted for "such use of the premises as is usual and incidental to the business conducted therein" and for "existing and increased hazards" and for "change in use or occupancy" . . . "*except as to any specific hazard, use or occupancy prohibited by the express terms of this policy.*" (emphasis added). Permission is also granted for the building to be "in course of construction, alteration or repair" and "to build additions thereto".

Defendant relies on the "Conditions Suspending or Restricting Insurance" clause (lines 28-31) as an express prohibition within the meaning of Paragraph 19. That clause provides that the company will not be liable for loss occurring "(a) while the hazard is increased by any means within the control or knowledge of the insured" or "(b) while a described building . . . is vacant

or unoccupied beyond a period of 60 consecutive days.”

The Court finds from the evidence that the building in question was not vacant or unoccupied beyond a period of 60 consecutive days; further, that the hazard was not increased by any means within the control or knowledge of the insured; that neither the vacating of the building by the sisters to the extent already described, nor the auction sale of personalty already mentioned, nor the entry or acts of demolition subcontractor’s representative already mentioned, nor any other means within the knowledge or control of the insured, increased the hazard of the company’s risk of fire loss over what the risk was when the policy was issued in 1961; that the building exterior was in its usual condition and appearance, and nothing about it was such as to invite arsonists or otherwise increase the hazard of fire; that the interior of the building, although vacant to the extent already described was not in any condition that would increase the hazard of fire.

The cases cited by defendant are not comparable to these facts. For example, in *Rizzuto v. National Reserve Ins. Co.*, 92 C.A.2d 143, 206 P. 2d 431 (1949) the risk, expressly limited to use of a building as a barber shop, was found to have been increased by its use as a dry cleaning establishment. In *Goldman v. Piedmont Fire Ins. Co.*, 198 F.2d 712 (3rd Cir. 1952) the building had partially collapsed and its condition, unrepaired by the insured, was found to have increased the fire hazard.

Prior to the fire loss the sisters, according to witness Shobring Building Inspector for the City

of Berkeley, had been served in February, 1961, July, 1963 and August, 1963, with certain Notices of Non-Conformity to the Berkeley Building Code (Ex. P). Although no action was taken by the sisters to conform the building, the necessary Occupancy Permits were, nevertheless, issued by the city to the sisters for each year from 1961 through 1965 and no other or further action of any kind had been taken by the city up to the time of the fire.

It thus appears and the court finds that the sisters' use of the building up to the time of the loss was with the approval of the city under this pattern of regular issuance of annual Occupancy Permits.

For the foregoing reasons the court concludes that the defendant's policy of insurance was not suspended by any act of the insured increasing the company's risk over what the risk had been when the policy was issued, as contended by defendant, and that the policy was in full force and effect at the time of the fire loss. (RT p. 150, line 9, p. 152, line 11.)

The court correctly interpreted the policy and the evidence as it applied to the policy in determining that no increase in hazard, other than that authorized by the policy itself, had occurred.

Appellant again seeks to avoid the specific terms of its own policy, depart from the evidence as presented to the court, and avoid the conclusions of the court by suggesting the application of rules of law that do not apply to this fact situation. Further, appellant fails to cite one specific item of evidence to bolster its claim.

Appellant bases this claim of increased hazard on the demolition of the building:

“Paragraph 19 did not permit the Sisters to increase the hazard to the building without limitation. The permission granted for increased hazard was clearly restricted, . . . and . . . excluded the demolition of the building.” (Appellant’s Opening Brief p. 63.)

Appellant conveniently disregards the testimony of their own witness, Abdo Allen, the demolition contractor:

“Q. Mr. Ford: In point of time, Mr. Allen, when did you *begin your demolition*, before or after the fire?

A. Well, we couldn’t start without permits. We got them on the 9th, so it would be *after the fire*.

Mr. Ford: Thank you, Mr. Allen.” (RT p. 210, lines 12-17.)

Interpretation of Policy.

Although it is applicable to every issue involving the interpretation of a provision of the insurance contract, the principle that the court will resolve any doubts or ambiguities in favor of the insured, applies most strongly to the matter of suspension of coverage for increased hazard.

“Foremost among them is the rule that since an insurance policy is drawn by the insurer, and since the insurer is bound to use such language as to make the provisions of the contract clear to the ordinary mind, any

ambiguity, uncertainty, or reasonable doubt is to be resolved by a construction in favor of the insured, or of the beneficiary claiming under the policy. Another frequent expression of the rule is that where the language is reasonably susceptible of two constructions, it should be construed in favor of the insured. A similar statement often made is that an insurance policy must be so construed, if fairly warranted, as best to carry out the object of securing indemnity to the insured for losses to which the insurance relates, rather than to narrow the protection of the policy.

To have the benefit of any of these propositions it is not necessary to show that the construction against the insurer is more logical than the one against the insured; it is sufficient to show that the construction in favor of the insured is equally reasonable with the contrary one." 27 Cal.Jur.2d 773 § 276.

Further basic treatise law on this subject points out that policies of insurance will be interpreted to avoid forfeitures:

"The courts are strongly inclined against forfeitures in insurance contracts, or at least do not favor them, and are disposed to seize upon slight circumstances to prevent them. Accordingly, where it is reasonably possible an insurance policy will be construed so as to avoid forfeiture, either by determining that a forfeiture has not occurred or that it is deprived of its effect by waiver or estoppel. This applies particularly to forfeitures on technical grounds that have no substantial relation to the interest of the insurer with regard to the risk assumed." 27 Cal.Jur.2d 775, § 278.

The court, in its opinion, decided, after a thorough review of the evidence, that the hazard had not been increased so that a forfeiture of the policy occurred. This determination was further based upon the "permission" clause of Paragraph 19 of the policy, giving permission for "existing and increased hazards" and for change in "use and occupancy".

Appellant cannot complain about an interpretation of its own policy favorable to the insured in light of the evidence presented and in light of the basic principles of law applicable to such interpretation.

Appellant's contention of forfeiture for increased hazard should be rejected by the Court of Appeals as it was by the District Court.

POINT VI

INTEREST BEGAN TO RUN SIXTY DAYS AFTER PROOF OF LOSS WAS RECEIVED.

The law in the State of California and the insurance policy itself is quite clear on this point:

"Appellant's final assertion is that the trial court erred in awarding respondents interest commencing at the date of the loss. This contention is valid. The policy specifically provides that any loss for which the company may be liable 'shall be payable 60 days after proof of loss . . . is received . . . and ascertainment of the loss is made either by agreement between the insured and this company . . . or by the filing with this company of an award as herein provided.' The general rule in regard to interest where the policy in question contains a provision of this nature

is that the principal payable under the policy will not bear interest for any time before the period so provided has expired, but will bear interest from that time. Our California courts have followed this rule." (See *Koyer v. Detroit Fire & Marine Ins. Co.* (1937) 9 Cal.2d 336 [70 P.2d 927].)

Hughes v. Potomac Ins. Co., 199 C.A.2d 239, at pp. 253, 254.

The Proof of Loss was received by defendant on June 23, 1966. (Defendant's Answer to Complaint, p. 3, lines 1 and 2.) Sixty days thereafter is August 22, 1966. Interest on the Judgment should run from that date. This is in accordance with the provisions of the policy, lines 143-148:

"When loss payable. The amount of loss for which this company may be liable shall be payable 60 days after proof of loss, as herein provided, is received by this company and ascertainment of the loss is made either by agreement between the insured and this company expressed in writing or by the filing with this company of an award as herein provided."

Royal Insurance Company, Limited, Policy No. WKF 656827.

Based both upon the law and the policy, the finding of the District Court was proper:

"With interest at the legal rate of seven (7) per cent from August 22, 1966, the date when the loss became payable under the terms of the policy (lines 143-148), together with costs of suit herein incurred."

(RT p. 159, lines 27-30.)

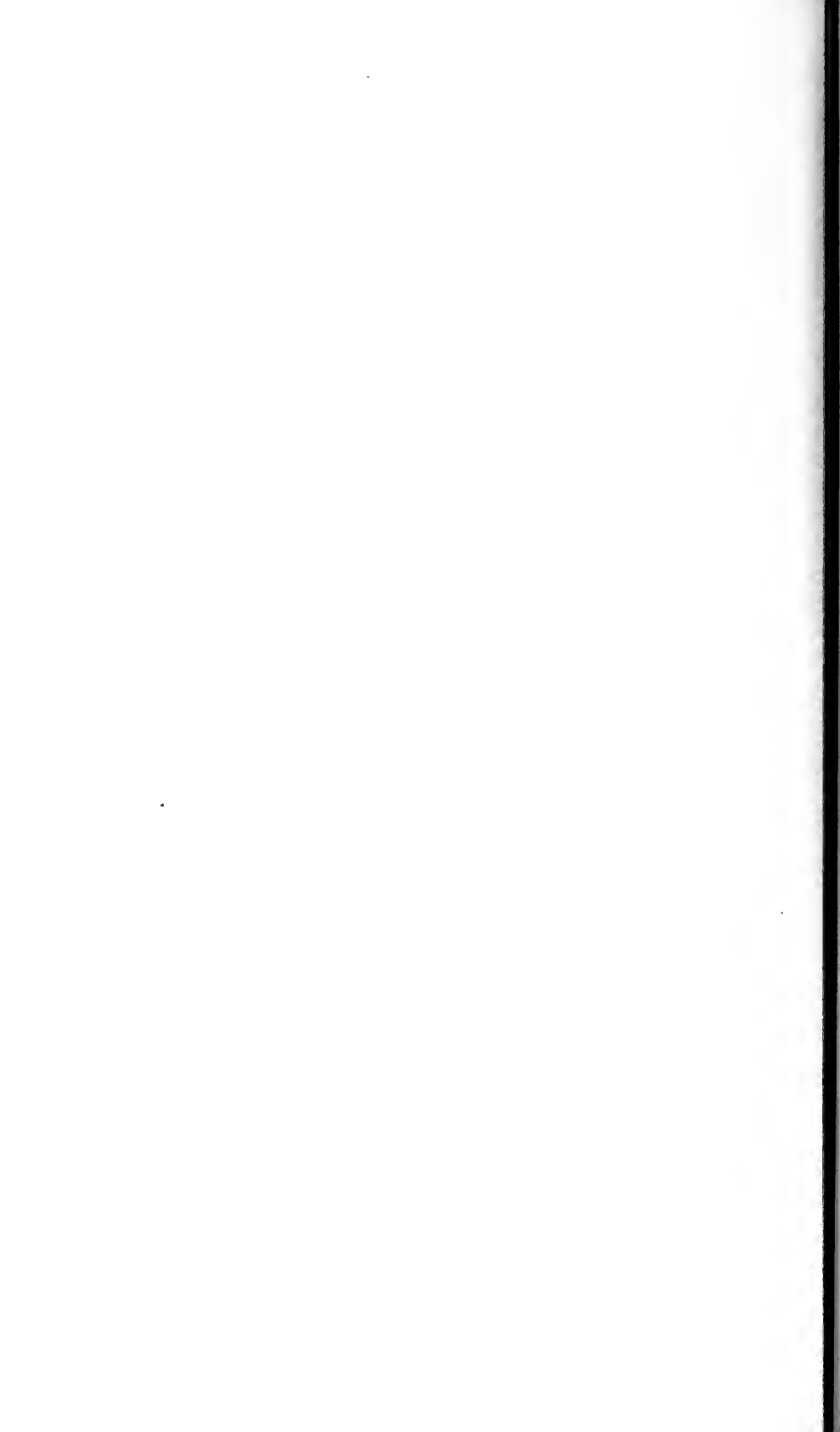
No error was committed in thus awarding interest. This determination should be upheld on appeal.

CONCLUSION

The judgment of the District Court should be affirmed based upon the comprehensive analysis of the evidence, establishing the facts, as applied to the applicable law as set forth in the most comprehensive opinion of the District Court.

Dated, San Francisco, California,
January 6, 1969.

Respectfully submitted,
TOBIN & TOBIN,
By JOHN J. FORD, III,
Attorneys for Appellee.



No. 23009

In the

FEB 21 1959

United States Court of Appeals

For the Ninth Circuit

ROYAL INSURANCE COMPANY, LIMITED, a
foreign corporation,

Appellant,

vs.

THE SISTERS OF THE PRESENTATION, a
corporation,

Appellee.

On Appeal from the United States District Court
for the Northern District of California

Reply Brief of Appellant Royal Insurance Company, Limited

FILED

AUGUSTUS CASTRO,
JOHN D. HOFFMAN,

The Alcoa Building,
One Maritime Plaza,
Golden Gateway Center,
San Francisco, California 94111

WM. B. LUCK

FEB 19 1959

*Attorneys for Appellant
Royal Insurance Company, Ltd.*

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PRELIMINARY STATEMENT

The brief filed on behalf of plaintiff-appellee* The Sisters of the Presentation (hereinafter "the Sisters") explicitly adopts the language, reasoning and authorities in the Memorandum of Decision filed by the court below (R. 146-60) as a

*Inasmuch as most of the references to the parties in this reply brief are in the context of the briefs on appeal and the contentions therein, the terms "appellee" and "appellant" will be generally employed herein.

substitute for independent analysis and argument of the issues presented on this appeal. Brief for Appellee 2 (hereinafter cited as Br. Appellee).

The issues presented on this appeal are set forth at pages 1-3 of the opening brief filed by defendant-appellant herein. (Hereinafter cited as "Open. Br."). The opening brief contains a thorough analysis of each of these issues and an extended development of appellant's legal position.

Because of the length of the opening brief, appellant will not undertake in this reply brief to summarize or restate its previous contentions or to elaborate further upon the authorities offered in their support. The validity of these contentions is not diminished by appellee's repeated quotation of the errors in the Memorandum Decision to which the opening brief is specifically and systematically addressed. The limited focus of this reply brief is not intended as an admission that the analysis and argument of the opening brief has been answered. On the contrary, at this writing it stands unrebutted.

STATEMENT OF THE CASE IN REPLY

(Open. Br. 3-8; Br. Appellee 2-6)

Statement of Jurisdiction

The parties are agreed that the Court below had jurisdiction to try this action and that this Court has jurisdiction on this appeal from the judgment entered therein.

On October 11, 1968, defendant-appellee Royal Insurance Company, Limited (hereinafter referred to as "Royal") filed a motion in the District Court under Federal Rule of Civil Procedure 60(b)(2) for relief from the judgment because of newly-discovered evidence and on other grounds.

On the same date Royal also filed a motion with this Court to remand the cause to the District Court for consideration of the Rule 60(b) motion. On October 14, 1968, this Court stated that it would withhold action on the motion to remand pending the advice of the District Court as to whether it desires to entertain Royal's motion there under Rule 60(b). Said motion was argued and submitted in November 1968, but at this writing the District Court has not indicated whether it desires to entertain the motion.

Statement of Facts

The Statement of Facts at pages 3-6 of the Brief for Appellee does not discuss or even refer to any of the testimony given by some fifteen witnesses at the five-day trial of this matter. Evidently appellee does not dispute the summary of that testimony which appears at pages 4-12 of the opening brief.

Appellee's Statement of Facts consists of a verbatim quotation of the order entitled "Summary Adjudication of facts not in Controversy and Duly Established," R. 61-63, as modified, R. 83-84, which the court below entered before trial. To this appellee has added a summary of correspondence and other contacts between the parties and their counsel after the fire, none of which is germane to any of the issues presented on this appeal. Br. Appellee 4-6.

Appellee's recitation of the order of summary adjudication as a statement of the facts in this lawsuit is thoroughly inconsistent with the position taken at pages 26-28 of its brief that all of the issues in this case were thoroughly litigated by means of the presentation and consideration of testimonial and other evidence at trial.

Summary adjudication of the question of the Sisters' insurable interest was error, for the reasons set forth at pages 30-32 of appellant's opening brief. For this Court now to determine that issue, or any other presented on this appeal, without regard to the evidence produced at the trial would needlessly compound that error.

ARGUMENT

I. The Sisters Had No Insurable Interest in the Old Convent at the Time of the Fire. (Open. Br. 14-30; Br. Appellee 7-24).

Appellee's argument in response to the contention that the Sisters had no insurable interest at the time of the fire reduces itself to the single assertion that the Sisters' execution and performance, before the fire, of a contractual commitment to the transfer and demolition of the old convent building were "collateral" events having no effect upon their insurable interest. See Br. Appellee 7-19. This incantation is offered at frequent intervals despite the explicit warning in the case on which appellee most strongly relies, *Wolf v. Home Ins. Co.*, 100 N.J.Supp 27, 241 A.2d 28 (1968), that there is no profit from trading in labels and that cases of this nature are to be decided on their individual facts. 241 A.2d at 33. The distinguishing facts of this case are that the Sisters received the full exchange value of the old convent before the fire, that they had no further interest in its preservation, and that they suffered no pecuniary loss or other detriment from its destruction. Open. Br. 7-8, 14-21.

In support of its argument appellee quotes repeatedly and at length from the decision of a New Jersey trial court in the *Wolf* case, apparently on the premise that it is harmonious with *Hughes v. Potomac Ins. Co.*, 199 C.A.2d 239 (1962) (the only California decision cited by appellee in its entire

61-page brief) in stating the law of California. Appellee contends that these decisions are exemplary of a "New York rule," adhered to by California, which makes recovery under an insurance policy independent of "collateral" events. In this connection appellee further argues that *Smith v. Jim Dandy Markets, Inc.*, 172 F.2d 616 (9th Cir. 1949), an applicable decision of this court discussed at page 25 of the opening brief, stands for a contrary "Wisconsin rule" that the California courts have rejected. Br. Appellee 19. The *Jim Dandy* decision does not cite, discuss or rely in any way on the "Wisconsin rule" or the case of *Ramsdell v. Insurance Co. of North America*, 197 Wis. 136, 221 N.W. 654 (Wis. 1928), from which it stems. Neither the "Wisconsin rule" or the "New York rule" had any application to the facts of that case, which involved the effect upon the insured's insurable interest of a transaction consummated *before the fire*. For the very same reason appellant Royal does not contend for the application in this case of the "Wisconsin rule" or any other rule dealing with the effect of events occurring after the fire.

Both the *Hughes* and the *Wolf* cases were discussed and distinguished in appellant's opening brief at pages 26-27 and 56-57 thereof. At the risk of some repetition these two cases will be further analyzed herein.

The *Wolf* and *Hughes* cases each deal with situations in which the insured was ultimately saved harmless from a fire loss by a third party's action subsequent to the fire, based on a contract obligation or voluntary undertaking which had not been performed at the time of the fire. They have no application to a case such as this one, where the insured suffered no loss with respect to the insured property because it received the property's full agreed exchange value in a transaction that was fully performed before the

fire—land was deeded, and a new convent and chapel were erected, furnished and occupied.

In *Wolf v. Home Ins. Co.*, 100 N. J. Sup. 27, 241 A. 2d 28 (1968), the insured had made an agreement five months before the fire to sell his apartment house to the State in lieu of condemnation. The State posted signs announcing its possession, but made no payment of any kind to the insured. Fire damaged the building. Five months later, the State paid the insured the sale price agreed to before the fire and took title to the property. In the insured's action on the policy, the insurer contended that the insured had sustained no loss from the fire because of the State's subsequent purchase of the property and payment of its "full value."

The New Jersey court emphasized at every juncture in its opinion that the only question before it for decision was whether *subsequent collateral events* could affect its determination of whether the insured suffered a loss at the time of the fire.

The court formulated the question before it as follows:

"Does the 'loss' become fixed as of the date of the fire so that, as long as the insured has an insurable interest at that time, the insurer becomes obligated to pay under its policy; *or can subsequent collateral events, such as the fact that the sale between insureds and the State of New Jersey was ultimately consummated nearly five months after the fire, with insureds receiving the full previously agreed upon contract price, be taken into account in determining the existence of an insurable 'loss'?*" 241 A.2d at 31. (Emphasis added.)

In stating its decision, the court quoted with approval, and emphasis supplied, the language of the Pennsylvania Supreme Court in *Dubin Paper Co. v. Insurance Co. of North America*, 361 Pa. 68, 63 A.2d 85, 96 (1949), describing the policy of insurance as:

“a liability the insuring companies cannot escape by anything any third parties may later do for the insured’s benefit.” 241 A.2d at 40. (Emphasis added.)

The complete disparity between the situation in the *Wolf* and *Hughes* cases and the question for decision here can best be appreciated by hypothetically modifying the facts in *Wolf* to make them analogous to those in the case at bar. Suppose that in the *Wolf* case the State had paid the insured the full purchase price of \$27,000 before the fire, so that he had the cash in hand at that time, but that for some reason the State had not formally taken title to the property from the insured. Could it seriously be argued that the *Wolf* court would then have applied the same principles as it did in the case actually before it? Is it at all conceivable that the court would have awarded the insured an insurance payment of \$25,000 for property in which he had no remaining interest at the time of the fire, merely by reason of the technicality that the State had not formally taken title to the property commensurately with its payment of the full purchase price? Of course not. But this would be precisely the equivalent of the appellee’s claim in this case that the Sisters, who *before the fire* had agreed to exchange their property with the Bishop, had received the property’s full agreed exchange value in the form of a new convent they had already occupied, and had surrendered the property to the Bishop and his agents, may yet recover the face value of \$210,000 under their insurance policy, upon the technicality that the Bishop did not trouble to obtain a formal bill of sale to the building—a building which it was his intention, and his unassailable legal right, forthwith to demolish.

Because the formality of a bill of sale was not adhered to, appellee would have this court disregard all of the evidence

at trial showing the intention of the Bishop and the Sisters in making their agreement and their performances of the agreement in strict adherence thereto. Such was the position adopted by the court below in ruling summarily that the Sisters retained their insurable interest to the time of the fire. The *Jim Dandy* decision of this court is direct and controlling authority against so obliterating the manifest purpose and effect of the transaction by a hypertechnical emphasis on formalities. See Open. Br. 25, 30-31.

Appellee's attempted equation of the Sisters' paper title to the building with an insurable interest therein is unsupported by the statute or decisional law of this State. The authorities cited at page 14 of the opening brief establish that the insured must stand in such relation to the property insured that he has a direct pecuniary interest in its preservation and will suffer pecuniary loss as an immediate result of its destruction. Such a relation of the Sisters to the old convent was nullified by the Bishop's complete performance of the acts for which the Sisters had exchanged their rights to the old convent; namely, the Bishop's construction and readiness for occupancy of a new convent building, evidenced by the Sisters' moving into the new building before the fire. That the rest of the Bishop's master plan, including his utilization of the old convent site, was, in appellee's phrase, "futuristic," (Br. Appellee 15) is totally irrelevant, as much so as the Highway Department's future plans for the apartment building site in the *Wolf* case.

Compelled by his theory to do so, appellee falsely attributes to appellant the position that the Sisters' insurable interest was divested by events occurring subsequent to the fire; specifically, the building's final demolition by Abdo S. Allen. Br. Appellee 19-22. Appellant's opening brief takes the position that the time of the demolition was an adventi-

tious circumstance without relevance to the issue of insurable interest under the facts of this case. Open Br. 21. Appellant adheres to that position. Appellee quotes testimony from Abdo Allen (Br. Appellee 13-14, 57), intending to establish that the demolition did not begin until the day after the fire. The Allen testimony quoted in appellee's brief is readily identifiable as a self-justifying legal conclusion, rather than a statement of fact, borne of the witness' acute awareness that "we couldn't [lawfully] start [the demolition] without permits. We got them on the 9th, so it would be after the fire." There is undisputed testimony in the record that Allen's employee, Neal, spent the entire day before the fire on the premises, salvaging material from the building, (Open. Br. 8; Tr. 212-214), and that \$52,000 in fixtures had been removed from the building prior to the fire. R. 159; Open. Br. 7.

II. The Judgment Must be Reversed Because the Trial Court Failed to Apply the "Broad Evidence Rule" in Determining the "Actual Cash Value" of the Property. (Open. Br. 33-57; Br. Appellee 29-53).

The parties are agreed that the court below was obliged under California law to apply the "broad evidence rule" of *McAnarney v. Newark Fire Ins. Co.*, 247 N.Y. 176, 159 N.E. 902 (1928), and succeeding cases, in determining the "actual cash value" of the property insured. Open. Br. 33-39; Br. Appellee 29-31.

Appellee's assertion that the trial court did in fact apply the "broad evidence rule" is manifestly unsupported by the record. As proof of this assertion, appellee fastens upon the amount of \$52,000 which the court deducted from the building's overall replacement cost as the value of fixtures removed from the building and the insured premises before

the fire, and contends that this action is inexplicable except on the hypothesis that the broad evidence rule was applied. Br. Appellee 29-30; 52.

The court's discussion of the \$52,000 of removed fixtures in its Memorandum of Decision demonstrates precisely the opposite of appellee's contention; namely, that the court was concerned throughout only with the replacement cost (less depreciation) of the building and its fixtures.

Referring to the undisputed testimony "that some fixtures had been removed by the Sisters from the old building before the fire," the court held that "the insurance company should not be required to absorb *the replacement cost* of these items," "that the only *evidence in the record as to their replacement cost* is the testimony of Horton," and that "*a reasonable allowance for the replacement cost* of these items . . . is \$52,000." R. 159. (Emphasis added). What better evidence could there be that the court was concerned purely and simply with the replacement cost of the property insured, and not with determining its actual cash value under the "broad evidence rule"?

Even without such unambiguous evidence that the court employed replacement cost as the measure of value, its deduction of \$52,000 from the estimates of plaintiff's witnesses would lend no support to the contention that the broad evidence rule was applied. The evidence showed that the items for which the court made the allowance had been sold at auction or otherwise removed from the premises prior to the fire, and that these items had been taken from the premises before the fire occurred. These facts were unknown to the plaintiff's witnesses, so their estimates of replacement cost were inclusive of the removed items. See R. 159; Tr. 413-14. In subtracting the replacement cost of these items from those estimates, the court was not modify-

ing or abandoning replacement cost as its measure of the actual cash value of the property that was actually destroyed, but merely excluding the replacement cost of items that were not so destroyed. No other interpretation of the court's action or of the accompanying explanation in its Memorandum of Decision can be seriously put forward.

The remaining portion of appellee's argument that the court actually applied the "broad evidence rule" is in the form of protracted excerpts from the manuscript, substantially unedited and designed to show that the court applied the "broad evidence rule" but disregarded all of defendant's evidence because it was unworthy of belief. Once again this presentation has the effect, presumably unintended, of establishing substantially the opposite of the point contended for by appellant. The impression thus supplied is fortified by the court's Memorandum of Decision showing that it regarded the testimony of plaintiff's witnesses as evidence only of replacement value, less depreciation, and rejected defendant's evidence because it thought the evidence to be legally irrelevant.

The testimony of the witnesses Hunt and Newkirk set forth at pages 32-41 of appellee's brief merely evidences two slightly different approaches to determining the replacement cost (less depreciation) of the building at the time of the fire. See especially Br. Appellee at pages 34, 40. The witness Newkirk even testified that the purpose of his appraisal was "to establish the replacement value of the property based on the cost, at the time of the fire." Br. Appellee 36. The witness Madsen, whose testimony is set forth at pages 42-44 of appellee's brief, affirmed no less than three times that his estimates represented the building's "replacement cost."

The testimony of these witnesses takes no account of the many other facts and circumstances "logically tending to the formation of a correct estimate of the building's value,"

the influence of which in this case is thoroughly analyzed at pages 43-49 of appellant's opening brief. The contention that the witness Newkirk considered all of the facts relevant under the "broad evidence rule" in his determination of the building's depreciation, Br. Appellee 40-41, is without substance. Mr. Newkirk offered this revelation, which in no way affected his previous valuation of the building at \$219,837.78, on redirect examination after specifically testifying on cross-examination: (1) that he had determined depreciation by considering the state of the plumbing, wiring and heating; (2) that he was not concerned with function in making his appraisal; (3) that he was concerned with the cost of replacement only; (4) that he did not consider the building's impending demolition; and (5) that he did not determine or consider the unremedied violations of the Berkeley Building Code or the cost of correcting the violating conditions. Tr. 109-11.

The suggestion that the cost of repair testified to by the witness Saleme (see Br. Appellee 41-42) supplied the court with facts relevant under the "broad evidence rule" is equally groundless. Saleme's testimony was offered to prove that the replacement cost of the building did not exceed its cost of repair, and for no other purpose. The court so states in its Memorandum of Decision. R. 153.

Appellee seeks to show that the court disregarded the testimony of appellant's witnesses because they were all "destroyed" on cross-examination. As evidence of such "destruction" in the case of Building Inspector Shobring appellee cites testimony that he issued the Sisters permits of occupancy during each year preceding the fire, notwithstanding the numerous Building Code violations he reported to his superiors. This testimony is very fully discussed at pages 61-62 of appellant's opening brief. It was not evidence of anything except the disinclination of Shobring and his

superiors to put the Sisters out on the sidewalk, there to await the completion of the new convent which these officials knew to be awaiting, or in the course of, construction. See Tr. 192. And it did not contradict Shobring's testimony that, in the quite different situation which obtained after the Sisters had the utilities disconnected and vacated the building on their own volition, the Sisters could not have reoccupied the building without bringing it to Code.

Appellee argues that the testimony of the witness Gilbertson, who testified to the \$121,000 cost to conform the building to Code, was worthless because the witness did not label it as an estimate of the building's "actual cash value." The point of the broad evidence rule, which consistently escapes appellee, is that the trier of fact "may, and *should* . . . consider every fact and circumstance which would logically tend to the formation of a correct estimate of the loss," and from that evidence arrive at his own sound determination of the property's "actual cash value" at the time of the fire. See Open. Br. 37. The witness' testimony bore directly on such facts and circumstances, and appellee's attempt to disparage it because it was not encased in legal terminology does not detract from its relevance.

Appellee asserts that the witness Horton was disqualified because his testimony was based in part on the cost estimates of others. Br. Appel. 49-51. Horton was as much entitled to use such an estimate as a partial foundation for his own, more comprehensive opinion, as was plaintiff's witness Hunt, who got his costs "from various services, like Marshall Stevens . . . and various associations with cost analyses, people who are working with it all the time." Tr. 65-66; Br. Appellee 33.

Appellee's final contention is that the court specifically took into consideration each of the factors listed at pages 52-53 of appellee's brief. This contention cannot survive even a cursory examination of the court's Memorandum of Decision.

The court below was most forthright in stating its method for determining "actual cash value." Page 7 of the Memorandum of Decision states that:

"The measure of recovery for a building fire loss is the value of the building as it stood on the day it was destroyed, taking into consideration the cost of rebuilding or repair and allowing for the difference in value between a new building and the condition of the building just before the fire." R. 153.

Immediately following that pronouncement, the court summarizes the testimony on which it relies in this manner:

"The evidence in this case given by the two well qualified expert appraisers is to the effect that the actual cash value of this convent building in its condition just before the fire was, according to witness Hunt, \$230,000 (*replacement cost, \$456,000, depreciated by 50 per cent*); according to witness Newkirk, \$219,837 (*replacement cost, \$439,000, depreciated by 50 per cent*).

These figures are fairly comparable to defendant company's own appraisal of the building in July, 1963, which, according to witness Madsen, was \$207,370, (*replacement cost \$330,000, depreciated by 35 per cent*)." R. 153 (emphasis added).

Where in this formulation of the court's rule of decision and its summary of the evidence relied upon is there reflected any consideration whatsoever of the matters relevant under the "broad evidence rule" which are listed at page 52-53 of appellee's brief and fully discussed at pages 43-49 of appel-

lant's opening brief? Only after determining the building's value without regard to these matters does the trial court turn to defendant's contention that "other factors;" *i.e.*, factors other than replacement cost, depreciation, and the comparative cost to repair, should be "taken into consideration." R. 153.

After discussing the building's lack of conformity to the Berkeley Building Code and the witness Horton's testimony concerning the costs of conforming the building thereto, the court declares that:

"It does not follow . . . that the Sisters are not entitled to the actual cash value of their building *measured by the cost of replacement or repair to its actual condition just before the fire* . . . (R. 154-55) (Emphasis added).

The court could scarcely express more clearly its opinion that the evidence it has just discussed is of no consequence either to the measure of damages, or to the amount thereof.

The court follows the same procedure in respect to the evidence concerning the Sisters' contract with the Bishop and the parties' performance thereof prior to the fire. The court states defendant's contention that the evidence "should be considered," and then proceeds to distinguish the McAnarney case and to state that the evidence should not be considered because:

"... indemnity to the insured . . . should not be made to depend upon the special and peculiar circumstances of the insured, e.g., his intentions or plans for the building, his contracts with others concerning it or the uses to which it can or cannot be put as distinguished from the intrinsic value of the building at the time of loss." R. 155.

The Memorandum of Decision makes clear throughout that the court was not suggesting any involved metaphysical concept of what constitutes the "intrinsic" value of the build-

ing, but was interpreting this to be the cost of reproducing the building, "taking into consideration the cost of rebuilding or repair and allowing for the difference in value between a new building and the condition of the building just before the fire." R. 153.

The trial court's error in failing to apply the "broad evidence rule" was not obviated by its admission of evidence relevant under that rule, which the court specifically declined to consider by improperly equating actual cash value with replacement cost, less depreciation. Findings of fact by the court upon evidence, although ordinarily insulated from appellate review under Federal Rule of Civil Procedure 52(a) unless "clearly erroneous," lose this immunity and become freely reviewable when they are induced by an erroneous view of the law. A judgment based on such findings may not stand. *E.g.*, *Fulton Nat'l Bank v. Tate*, 363 F.2d 562, 567 (5th Cir. 1966); *Smallfield v. Home Ins. Co.*, 244 F.2d 337, 341 (9th Cir. 1957). The trial court's finding that the property had an actual cash value of \$226,000 was obviously induced by its erroneous view that the proper measure of that value was the property's replacement cost less depreciation. This being the case, the judgment must be reversed and cannot be allowed to stand upon the premise that the evidence relevant to actual cash value under the "broad evidence rule" was in the record for such weight as the trial court saw fit to accord it.

A similar situation was presented to the California District Court of Appeal in *Lewis Food Co. v. Fireman's Fund Ins. Co.*, 207 C.A.2d 515, 523-24 (1962). There the trial court had permitted extrinsic testimony on the meaning of an ambiguous provision in an insurance policy, but "the record

afford[ed] no assurance that the trial court gave consideration to the evidence . . .” The appellate court held that:

“If, as appears to have been the case, the trial judge, although he did not refuse to receive extrinsic evidence, considered the policy to be of such a nature that it could and must be construed by a consideration of its terms alone, prejudicial error occurred.

* * *

[W]here the trial court refuse[s] to consider and weigh evidence upon the erroneous theory that it [can] not be considered, the appellate court is not justified in affirming the judgment upon the ground that the evidence supports the judgment.” 207 C.A.2d at 524.

Thus in this case, where the court’s opinion shows rather conclusively that it considered none of the evidence on actual cash value other than replacement cost and depreciation, prejudicial error was also committed and the judgment may not be affirmed.

III. The Sisters Increased the Hazard of Fire to the Building.

(Open. Br. 57-63; Br. Appellee 54-59).

Appellee has not answered appellant’s contention that the hazard of fire to the building was materially increased by the preparations for, and the beginning of, the building’s demolition. The applicable portion of the trial court’s opinion, which appellee quotes in full, is not responsive either to the legal authorities presented in appellant’s brief or to most of the evidence adduced therein.

Contrary to appellee’s baseless assertion (Br. Appellee 56) that the contention of increased hazard is presented without evidentiary support, the discussion at pages 58-62 of appellant’s opening brief draws repeatedly upon the evidence at the trial, all of which is presented with appropriate

references to the record in appellant's statement of facts. Open. Br. 4-8. This evidence showed *inter alia* and without contradiction that \$52,000 in fixtures had been stripped and removed from the building prior to the fire. It is appellee, and not appellant, who has assiduously avoided any discussion of the facts in this case—facts that appellee is unable to dispute. See Br. Appellee 3-6.

IV. Prejudgment Interest is Not Authorized by Civil Code § 3287. (Open. Br. 63-65; Br. Appellee 59-61).

This court has held *per curiam* that section 3287 of the California Civil Code does not authorize the award of interest prior to judgment where the actual cash value of property insured against fire must be determined upon conflicting evidence such as that presented herein. *Browner v. Pearl Assur. Co.*, 285 F.2d 120 (9th Cir. 1961). This decision accords with the rule announced by the California Supreme Court in the cases cited at page 64 of appellant's opening brief.

Hughes v. Potomac Insur. Co., 199 C.A.2d 239, 254 (1962), relied on by appellee, does not overcome these decisions by higher courts. In *Koyer v. Detroit Fire and Marine Ins. Co.*, 9 Cal.2d 336, 345-46 (1937), the sole authority cited therein, the insurer did not deny liability, and the court held that, under such circumstances, there was no right to insist on a judicial determination of the amount of the loss since the policy provided a procedure for ascertaining it and the amount awarded after trial conformed closely to that claimed in the proof of loss. In these proceedings the question of liability, the measure of damages, and the amount thereof have been the subject of contest throughout, and the court's award varied by some \$36,000 from the amount claimed in the proof of loss.

CONCLUSION

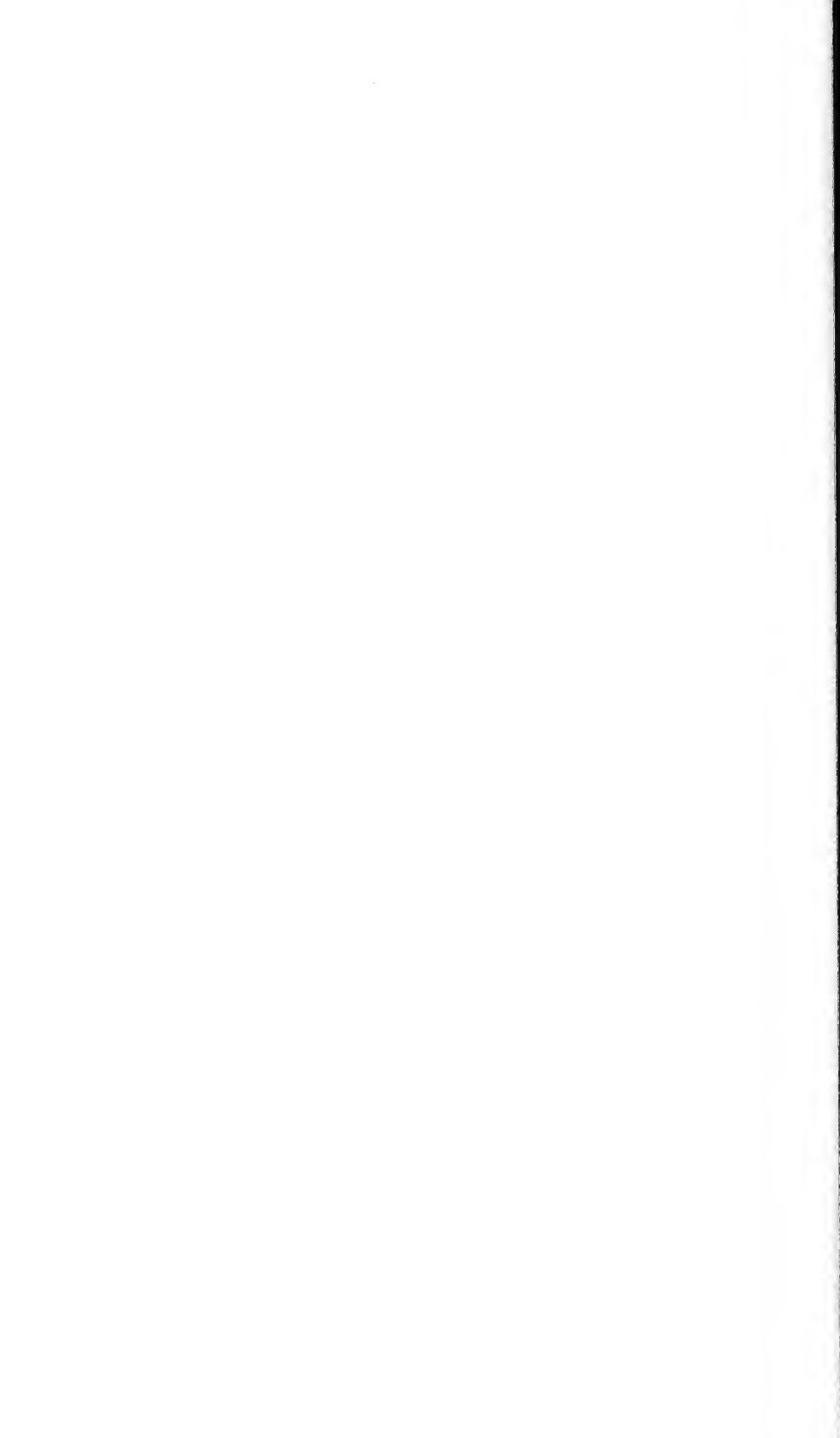
For the reasons set forth above, defendant respectfully submits that the contentions of appellant's opening brief are correct, and that this Court should reverse the judgment, remand the cause to the District Court, and otherwise take action as requested at pages 65-66 of appellant's opening brief.

San Francisco, California
February 5, 1969

Respectfully submitted,

AUGUSTUS CASTRO,
JOHN D. HOFFMAN,

Attorneys for Appellant
Royal Insurance Company, Ltd.



No. 23009

In the

FEB 20 1968

United States Court of Appeals

For the Ninth Circuit

ROYAL INSURANCE COMPANY, LIMITED, a
foreign corporation,

Appellant,

vs.

THE SISTERS OF THE PRESENTATION, a
corporation,

Appellee.

On Appeal from the United States District Court
for the Northern District of California

Brief of Appellant
Royal Insurance Company, Limited

FILED

AUGUSTUS CASTRO,
JOHN D. HOFFMAN,

DEC 9 1968

The Alcoa Building,
One Maritime Plaza,
Golden Gateway Center,
San Francisco, California 94111

WM. B. LUCK, CLERK

Attorneys for Appellant
Royal Insurance Company, Ltd.



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No. 23009

In the

United States Court of Appeals

For the Ninth Circuit

ROYAL INSURANCE COMPANY, LIMITED, a
foreign corporation,

Appellant,

vs.

THE SISTERS OF THE PRESENTATION, a
corporation,

Appellee.

On Appeal from the United States District Court
for the Northern District of California

Brief of Appellant

Royal Insurance Company, Limited

STATEMENT OF THE QUESTIONS PRESENTED

1. Did plaintiff have an insurable interest in the old convent building on the date of the fire? The trial court (William T. Sweigert, J.) held that plaintiff had such an insurable interest. See Argument, Part I, *infra*.
2. Was it proper for the court below to determine on motion for summary judgment that plaintiff had an insurable interest in the old convent building on the date of the fire? The court below

entered an order before trial reciting as "facts not in controversy and duly established" that plaintiff had such an insurable interest, and that the only issues remaining for trial were the extent of the building's damage by fire, plaintiff's compliance with the policy in certain respects, and the amount of damages to be awarded plaintiff. See Argument, Part I, *infra*.

3. What was the proper method under California law for determining the "actual cash value" of the old convent building to the plaintiff on the date of the fire? Specifically, was such value to be determined under the "broad evidence rule," requiring the trier of fact to consider every fact and circumstance logically tending to the formation of a correct estimate of plaintiff's loss? Or was such value to be determined solely by the cost of reproduction of the building, less its physical depreciation to the time of the fire. The trial court held the latter method to be the sole measure of actual cash value, and gave judgment for plaintiff accordingly. See Argument, Part II, *infra*.

4. Was it relevant to the questions of "actual cash value" and/or insurable interest that prior to the fire: (a) plaintiff had entered into a binding contract for the demolition of the (insured) old convent building; (b) that pursuant to this contract the Roman Catholic Bishop of Oakland had caused a new convent building to be constructed for plaintiff; (c) that plaintiff had moved into this new convent and had vacated the old convent building; (d) that the furnishings and a substantial part of the fixtures in the old building had been sold at auction and removed, and the building's utilities disconnected, in connection with its demolition; and (e) that final demolition of the building's remains was already in progress? The trial court, hearing the case without a jury, treated all of these facts as not relevant to either issue. See Argument, Parts I and II, *infra*.

5. Was it relevant to the questions of "actual cash value" and/or insurable interest that (a) prior to the fire the City Building Inspector of Berkeley had determined the old convent building to be a fire hazard and unfit for human occupancy;

(b) the City Building Department would not have permitted plaintiff to reoccupy the building after vacating it until it was brought into conformity with the Building Code; and (c) it would have cost plaintiff at least \$121,000 just to conform the building to the Code, without making all needed repairs or replacing all of the fixtures removed from the building before the fire? The trial court treated all of this evidence as not relevant to either issue. See Argument, Parts I and II, *infra*.

6. Did plaintiff increase the hazard of fire to the old convent building by means within its knowledge or control, thus suspending the policy? The trial court held that plaintiff did not do so. See Argument, Part III, *infra*.

7. Was plaintiff entitled to interest prior to judgment? The trial court held that plaintiff was entitled to interest on the amount of the judgment from the date the loss became payable under the policy. See Argument, Part IV, *infra*.

STATEMENT OF THE CASE

Statement of Jurisdiction

Plaintiff filed this action in the Superior Court of the State of California, City and County of San Francisco, on September 28, 1966. R. 1.¹ Defendant removed the case to the United States District Court for the Northern District of California by the timely filing of a petition for removal pursuant to 28 U.S.C. § 1441(a). *Ibid*. The District Court had jurisdiction in removal because the district courts of the United States would have had original jurisdiction of this action under 28 U.S.C. § 1332(a)(2), as a civil action between a citizen of the State of California and

1. All references to "R" herein are to Volume I of the Clerk's Transcript of Record, consisting of numbered pages 1-177 inclusive. All references to "Tr." are to Volumes II through V inclusive of the Clerk's Transcript of Record, consisting of the 4 volumes of the Reporter's Transcript of the proceedings at trial, containing numbered pages 1-468 inclusive. References to "Exh." are to Exhibits admitted into evidence at the trial, with numbered exhibits designating those introduced by plaintiff and lettered exhibits designating those introduced by defendant.

a citizen of the United Kingdom, a foreign state, in which the amount in controversy exceeds \$10,000. R. 2, 3.

After trial to the court sitting without a jury, a judgment was entered for plaintiff in the amount of \$174,000, together with legal interest thereon at the rate of 7 per cent from August 22, 1966. R. 161. The court filed a memorandum of decision dated April 22, 1968, stating its findings of fact and conclusions of law, pursuant to Fed. R. Civ. P. 52(a). R. 146. On May 10, 1966, defendant filed a timely notice of appeal from the judgment of the District Court, and from the previous order of the District Court dated August 16, 1967, as modified on November 24, 1967, and entitled "Summary Adjudication of Facts Not In Controversy and Duly Established." R. 162. This Court has jurisdiction of the entire appeal under 28 U.S.C. § 1291.

Statement of Facts

This is a civil action to recover the face amount (\$210,000) on a policy of fire insurance issued by defendant² to plaintiff³ on December 1, 1961, for a term of five years. R. 7-16.

The insured property was a three-story frame building known as St. Joseph's Convent (sometimes referred to hereinafter as the "old convent") and located at 2116 Jefferson Street, in Berkeley, California. The building was constructed in 1877. Tr. 44. Its only use for several years prior to the fire was as a residence for members of plaintiff on the faculties of St. Joseph's Elementary School and St. Joseph's (now Presentation) High School, operated by plaintiff and located nearby. Tr. 40-41, 45.

The insured property was substantially destroyed by fire on the night of June 8-9, 1966. Two youths were subsequently charged under Section 447a of the California Penal Code with wilfully setting fire to and burning the old convent, and pleaded guilty

2. Defendant Royal Insurance Company, Limited, is sometimes referred to hereinafter as "the company." Fed. R. App. Proc. 28(d).

3. Plaintiff The Sisters of the Presentation, a Roman Catholic religious order, is sometimes referred to hereinafter as "the Sisters" and as "the insured." *Ibid.*

to the lesser included offense (Penal Code § 452a) of possessing combustible materials with intent to burn buildings or property. Exh. 15.

Mother Mary Thaddea, the Vice President of plaintiff, and Sister Mary Mercedes, the Superior in charge of the convent, testified that the building constantly needed repair, was very costly to maintain and operate, and could not be improved without a great deal of money. Tr. 44-46, 178-79. For these reasons the Sisters entered into discussions with the Roman Catholic Bishop of Oakland concerning the possible construction of a new convent building to house the Sisters. *Ibid.*

On April 20, 1964, plaintiff and the Bishop executed an agreement for the construction of a new convent and the physical expansion of the existing St. Joseph's High School facilities. Tr. 31-33; Exh. A. Under this Master Plan, as it was referred to by the parties, Exh. E (April 5, 1965), Tr. 172-73, the Sisters agreed to use the parcel of real property owned by them, on which the old convent stood, in perpetuum for the expanded high school. Exh. A, ¶ 1. The Sisters were to own and operate the high school under the supervision of the Roman Catholic Diocese of Oakland. *Ibid.*

As part of the Master Plan, the Sisters agreed that that the old convent then standing on the property would be demolished to make way for the expanded high school facilities. Exh. A, ¶ 4; Exh. L; Tr. 41. The Bishop was to perform the actual razing operation and to assume the costs thereof, as well as the costs of preparing the leveled site for the high school's physical expansion. Exh. A, ¶ 4. The Bishop further agreed to construct at his expense a new convent to house 24 Sisters on other property then owned by the Bishop, but to be deeded to the Sisters pursuant to the Master Plan. *Id.* at ¶ 2, 3.

In furtherance of the Master Plan, plaintiff applied for, and obtained a use permit in January 1965 from the City of Berkeley. Exh. L. The purposes of the Master Plan, and its sequence of execution, as stated by plaintiff in the application on the basis of which the City issued the use permit (Exh. L) were as follows:

Erect a two-story convent to house 24 sisters to be located in the southeast corner of the site at Allston Way and Jefferson St. Permission is also requested in this application to demolish the existing convent, to pave that area for temporary use as a physical education area for the existing high school and to eventually erect a new high school for 600 students. This high school would replace the existing high school on the same site and would be located at the north end of the site adjacent to Addison Street. We feel that in this application we are not substantially changing the site use but simply replacing the outdated convent and high school with new facilities sited to make the most sensible use of the site. For that reason we feel our proposal is not in any way detrimental to this particular neighborhood.

Projected sequence of construction:

1. Building new convent.
2. Demolish existing convent.
3. Pave over area of demolished convent for use as P.E. area.
4. Build new high school.
5. Demolish existing high school.
6. Complete total site development work.

Plaintiff next applied to the City Council of Berkeley on April 5, 1965 for abandonment by the City of the entire block of Jefferson Street between Addison Street and Allston Way, to provide an integrated mall and recreation area in furtherance of the Master Plan for site development. Exh. E. On the basis of these representations by plaintiff, the City granted the application, and the street was abandoned and closed for the use of plaintiff. Exh. M; Tr. 173.

In furtherance of his own obligations under the Master Plan, the Bishop then entered into a contract, dated August 17, 1965, with Merle K. Garing, a general contractor, for construction of a new convent, demolition of the existing convent, and preparation of the old convent site for the high school's expansion. Tr. 224-26. Pursuant to authority granted him in his contract with the

Bishop, Garing then subcontracted the demolition of the old convent to Abdo S. Allen Company, a demolition specialist, by a subcontract agreement dated August 19, 1965. Exh. R; Tr. 227. The subcontract gave Allen all salvage rights to the building. Tr. 227, 204.

Garing then constructed the new convent—the first step in the Master Plan. On May 31, 1966, the Bishop and the Roman Catholic Welfare Organization of Oakland recorded a joint notice of Garing's completion of the new convent building as of May 18, 1966, subject to demolition of the existing convent—the next step in the Master Plan. Exh. O.

Prior to the new convent's completion, the Sisters contracted for an on the premises auction sale of the furniture and personal property in the old convent, Exh. B, Tr. 35-37, items that the Sisters no longer needed because the Bishop had fully furnished the new convent. Tr. 181-82.

Promptly following the new convent's completion, the Sisters moved out of the old convent and into the new building. Tr. 180. According to Sister Mary Mercedes, the convent Superior, the Sisters had all moved out of the old convent, at the very latest, by Friday, June 3, 1966, five days before the fire the night of Wednesday, June 8. *Ibid.*

On Saturday, June 4, the auction sale was held in the old convent. Tr. 37, 180; Exh. C. Sister Mercedes testified that the auction covered virtually everything in the old convent that could be detached and was saleable, and that nothing remained after the auction that could be utilized elsewhere by the Sisters. Tr. 181-82.

After the Sisters moved out and before the fire, the gas, electricity and other building utilities were disconnected in preparation for the final demolition. Tr. 181. During the same period, plumbing fixtures, electrical panels, electrical fixtures, and stained glass windows were removed, as were the furniture and other personal property sold at auction. Tr. 238, see Tr. 420-22. Thus, at the time of the fire, the old convent was vacant, unoccupied and uninhabitable.

Prior to the date of the fire the demolition subcontractor's men took down part of a fence around the convent. Tr. 208, 210-211.

On June 8, 1966, the day of the fire, an employee named Dewey Neal was sent by the subcontractor Allen to "strip" the building and remove the salvage. Neal spent the entire day working on the building, knocking down outside sewer pipes and throwing them onto the ground. Tr. 212-14. That night the fire occurred. Two or three days later the subcontractor proceeded to demolish what remained of the building. Tr. 182. Thereafter the site was cleared, paved, and used by the high school for physical education purposes in accordance with the Master Plan. Tr. 182-83.

On the morning after the fire, Sister Mercedes told Mr. Phillip W. Gale, an insurance adjuster employed by defendant, that the old convent was of no use to the Sisters because it "either was being or was going to be demolished," and because they had moved out prior to the fire and "were comfortably established in their new home." Tr. 230. Sister Mercedes confirmed in her trial testimony that the old convent was of no use to the Sisters at the time of the fire, except that "[they] might need it if anything would happen to [their] other convent." Tr. 181-82.

Statement of Other Principal Evidence as to Value

Mr. Paul Shobring, an inspector for the Building Department of the City of Berkeley, testified for defendant that he inspected the insured building on several occasions in the course of his duties. Tr. 187. On at least three occasions, beginning on February 27, 1961, Shobring served on Sister Mercedes, the convent Superior, notices of various Building Code violations that were grounds either for withdrawing the Sisters' occupancy permit for the building, or abating the premises. Tr. 188-190; Exh. P. One of these notices, dated August 2, 1963, contains the following summary of Shobring's observations at that time:

Plumbing lines need replacing. Inadequate toilet and washing facilities. Roof leaks. Stair enclosures needed. All walls in egress shall be "one hour" [fire] walls. Heating inadequate. Roof supports rotted in certain sections. Repair window sash and frames. *This building is a fire hazard to its occupants.* (Emphasis added.)

Although he inspected the convent after August 2, 1963, Shobring served no further notices of violation because, as he testified, the Sisters were already on notice to repair or rebuild the convent. Tr. 191-92. In addition, Sister Mercedes had informed him that a new convent would be built and that the Sisters did not wish to make any repairs on the old building. *Ibid.* Shobring last inspected the building within a year before the fire. At that time none of the violations recorded in his earlier inspections had been corrected. *Ibid.*

Shobring testified that his inspections led him to conclude that the building was "unfit for human occupancy," and that this conclusion prompted his delivery of the several notices of violations to Sister Mercedes. Tr. 193. He discussed the situation several times with Sister Mercedes, who agreed that the building was a fire hazard and unsafe for its occupants. Tr. 190-91.

Shobring was asked what effect the vacating of the building and disconnection of its utilities would have on the Sisters' occupancy of the old convent. He stated unequivocally that the Building Department would not allow the Sisters to reoccupy the building until it was brought into compliance with the Code. Tr. 192.

Mr. George Horton, a licensed real estate appraiser, testified for defendant as to the methods and results of his appraisal of the building's actual cash value at the time of the fire. In connection with his appraisal, Mr. Horton familiarized himself with the building's history and physical condition before the fire, and with the records of the Berkeley Building Department. Tr. 245. He also confirmed that the building was under contract to be demolished, and considered in making his appraisal that the Sisters had vacated the building, that its furnishings and substantial parts of its fixtures had been sold and removed from the building prior to the fire, that the utilities had been disconnected, and that the Building Department would not permit the building to be reoccupied until it complied with the Code. Tr. 245-48.

Based on these and other facts, Horton gave this opinion of the building's value immediately before the fire:

"[T]he value of the building was a negative value, to the extent of the cost of removal of the building.

* * *

The building was deteriorated and obsolete. It was certainly obsolescent and up to the time of moving out was obsolescent. Moving out and vacating would certainly tend toward making it obsolete. The equipment was removed from the building, furnishings, and a good bit of the realty removed in the way of such fixtures, doors, cabinets, panels. Power was disconnected, which means that to connect it, the building would have to be brought up to code. The sprinkler systems and one-hour fire walls and what not. Which certainly would make the property altogether a completely obsolete and completely depreciated piece of property." Tr. 248-49.

Later, on recall, Horton testified that the cost merely to bring the building up to Code would be \$121,000. Finally, he estimated that the value of the fixtures (as distinct from the furniture and personal property) removed from the building prior to the fire was \$52,500. Tr. 420-22.

Mr. John M. Gilbertson, a contractor specializing in fire damage repair work, also testified as to the convent's value, based on observations he made immediately after the fire and a series of meetings with officials of the Berkeley Building Department to determine their precise requirements for bringing the building from its condition before the fire into one in conformity with the Code. Tr. 429-34. Based on this information, Gilbertson estimated that the cost of the repairs required just to bring the building to Code from its condition before the fire would be \$120,785, itemized as follows (Exh. B-2):

| | |
|----------------------------|---------------------|
| Automatic Sprinklers | \$ 19,016.00 |
| Plumbing | 45,856.00 |
| Electrical Work | 10,360.00 |
| Roofing | 2,160.00 |
| Carpentry | 26,098.00 |
| Fire Escapes | 5,750.00 |
| Heating | 5,280.00 |
| Painting | 6,265.00 |
| Total | <u>\$120,785.00</u> |

Mr. David S. Costello, plaintiff's insurance broker, testified that upon taking over plaintiff's account in January 1963, he requested and obtained a valuation of the old convent from Mr. Elmer Ellis of the Continental Insurance Company, plaintiff's general insurance representative. Tr. 263-65. The Ellis report of February 23, 1963 estimated that, owing to depreciation alone, the actual cash value of the property was only \$35,000 at that time. Exh. A-1; Tr. 265-66; 272. Shortly thereafter, Mr. Costello inquired of defendant as to the possibility of placing on the policy covering the old convent a demolition cost endorsement to provide for the cost of demolishing the undamaged portion and bringing it to Code in the event of a loss, and a replacement cost endorsement to provide for the cost of replacing the building with material of like kind and quality, without deduction for depreciation. Exh. D; Tr. 138-140; 261. After his inquiry was answered, Mr. Costello did not ask the company for either of these endorsements. *Ibid.*

Plaintiff presented the testimony of two appraisers, each of whom testified to his estimates of the building's replacement cost and depreciation at the time of the fire, and to the "value" of the building at that time, represented by the difference between replacement cost and depreciation. The witness William E. Hunt concluded that the building's replacement cost, based on cost of reproduction per square foot, was \$456,000, and subtracted physical depreciation of 40 per cent and "physical" obsolescence of 10 per cent therefrom. Tr. 66-67; 94-97. After a few minor additions, his final estimate of the building's value was \$230,000. Tr. 67.

The witness Kenneth Newkirk concluded that the building's cost of replacement, based on a materials and labor cost survey, was \$439,675.56, and that physical depreciation was 50 per cent, resulting in a value of \$219,837.78. Tr. 106.

In forming their estimates, neither of plaintiff's witnesses took into consideration that the Berkeley Building Department had notified the building's owners of numerous Code violations and other defects in the building that were unremedied at the time of the fire. Tr. 78-80; 110. Nor did they ascertain whether it

would be necessary to remedy such violations before the building could ever be reoccupied. Tr. 84. They did not consider that the owners had decided to demolish the building or that the building had been vacated and the demolition begun. Tr. 78, 82, 109. Each testified that these facts, if considered, would have had little or no effect on his replacement cost estimate. Tr. 82-84; 109-110. Neither witness allowed for functional obsolescence of the building in his estimate. Tr. 94-95; 109.

Mr. R. E. Saleme, Jr., a repair contractor, testified that the building would cost \$237,552 to repair. Tr. 118. The purpose of his testimony was to show that the estimates of replacement cost less depreciation by Newkirk and Hunt did not exceed the cost of repairing the building. Saleme testified that his estimate of repair cost did not include any costs of bringing the building into conformity with the Code. Tr. 120-21; 386.

On recall, witness Newkirk testified that his estimate of 50 per cent depreciation, given in his initial testimony, included 30 per cent for economic obsolescence and 20 per cent for physical depreciation. Tr. 400-401. This contrasted with the witness Hunt's appraisal of 40 per cent physical depreciation. In his recall testimony Newkirk also testified that he had taken into consideration the costs of bringing the building up to Code. Tr. 405-06. He stated that he accomplished this by making room for such costs in the estimate of 50 per cent for physical depreciation that he had given in his initial testimony, Tr. 416-17. At that time he had testified that he did not consider any costs of bringing the building up to Code. Tr. 109-111.

The trial court found that the actual cash value of the building, just prior to the fire, was \$226,000. R. 159. Although not described as such by the trial court, this figure is approximately the arithmetic mean of the Hunt and Newkirk estimates of \$230,000 and \$219,837.78, based solely on replacement cost less depreciation. Referring to the Horton testimony, the court then subtracted \$52,000 as the value of the parts of the building removed before the fire and subsequently entered judgment for plaintiff in the amount of \$174,000, together with interest and costs. R. 159, 161.

SUMMARY OF ARGUMENT

Plaintiff had no insurable interest in the old convent building at the time of the fire. Plaintiff had lost its insurable interest as a result of: (a) the Agreement with the Bishop for the demolition of the old convent and its replacement by the new convent; and (b) the performance of that Agreement by the Bishop's construction of the new convent and plaintiff's vacation and surrender of the old convent for demolition.

The old convent had no substantial "actual cash value" to plaintiff at the time of the fire. Plaintiff had vacated the building pursuant to its Agreement with the Bishop and had permitted the utilities to be disconnected. The furnishings in the building and a substantial portion of its fixtures had been sold at auction or otherwise removed. Plaintiff had no further use for the structure and nothing of value remained therein. Demolition had begun and the remainder of the building was to be promptly demolished, as required by plaintiff's Agreement with the Bishop. Even had plaintiff desired to make use of the structure in any way, it was precluded from doing so because reoccupancy was prohibited unless violations of the Building Code were first remedied at great cost, and because the structure was physically uninhabitable.

Under California law the building's "actual cash value" was to be determined by considering all of the above facts and circumstances, and not by considering only its cost of replacement. So determined, the building's "actual cash value" to plaintiff at the time of the fire was insubstantial.

Plaintiff increased the hazard of fire to the old convent by means within its knowledge and control. Plaintiff did so by allowing the building to deteriorate so that it was not fit for occupancy under the Building Code, vacating the building, auctioning off its furnishings, permitting part of its fixtures to be removed, and by instituting demolition work on the building that broadcast the fact of its vacancy and made it freely accessible to outsiders.

The trial court improperly awarded interest prior to judgment. Interest could not commence to run until that time because the plaintiff's claim was unliquidated and substantially disputed.

ARGUMENT

I. Plaintiff Had No Insurable Interest in the Old Convent at the Time of the Fire.

A. UNDER CALIFORNIA LAW, AN INSURABLE INTEREST DOES NOT EXIST UNLESS THE INSURED WILL SUFFER PECUNIARY LOSS FROM DESTRUCTION OF THE INSURED PROPERTY.

California Insurance Code, Section 281, which is applicable in this diversity case, defines an insurable interest in property as:

Every interest in property, or any relation thereto, or liability in respect thereof, of such a nature that a contemplated peril *might directly damnify the insured* . . . (Emphasis added.)

It has long been established in California, in cases decided under this section and its predecessor (Section 2546 of the Civil Code), that an insurable interest exists only if, at the time of the fire or other event insured against, the insured "has a direct pecuniary interest in [the insured property's] preservation and . . . will suffer a pecuniary loss as an immediate and proximate result of its destruction." *Davis v. Phoenix Ins. Co.*, 111 Cal. 409, 414 (1896); *Martin v. State Farm Auto Ins. Co.*, 200 C.A.2d 459, 468 (1962); *Smith v. Jim Dandy Markets, Inc.*, 172 F.2d 616, 618 (9th Cir. 1949).

Thus, under California law, two conditions must coexist at the time of the fire for an insured plaintiff to have an insurable interest in property:

- a. The insured must have a *direct pecuniary interest* in the property's preservation; and
- b. The insured must suffer *pecuniary loss as an immediate and proximate result* of the property's destruction.

Neither of these two conditions was met in this case.

B. THE SISTERS HAD NO INSURABLE INTEREST IN THE OLD CONVENT AFTER THE EXECUTION OF THEIR AGREEMENT WITH THE BISHOP.

The Agreement with the Bishop dated April 20, 1964 specifically committed the Sisters to the demolition of the old convent building. The Agreement empowered the Bishop, at his own

expense, to tear down the old convent and prepare the site for future use by the adjoining high school.

This binding contractual commitment to the building's demolition was not just an incident to the building of a new convent by the Bishop. The demolition had a vastly greater importance under the parties' Master Plan. Indeed, it was indispensable for the achievement of their principal purpose.

The overriding purpose of the Agreement between plaintiff and the Bishop was to provide for expansion of the Presentation High School. To that end the Sisters agreed to use the real property owned by them at 2116 Jefferson Street (on which the old convent then stood) for the purpose of operating the high school. The old convent was an obvious obstacle to this purpose. The agreement thus provided that it be demolished and that a new one be built nearby.

The old convent's demolition was therefore a condition of the substantial benefits promised the Sisters under their Agreement with the Bishop. Once that Agreement was executed, the Sisters no longer had a direct pecuniary interest in the old convent's preservation. They certainly had no obligation to preserve the building intact for demolition. Far from having any interest—direct or indirect, pecuniary or otherwise—in the preservation of the old convent, their interest lay rather in its removal so that the more beneficial uses of the property provided for under the Agreement could commence. Whether this removal was accomplished by demolition at the Bishop's expense, as the Agreement provided, by accidental destruction, or by a combination of both, as in fact occurred, was a matter of no consequence to the Sisters.

Nor were the Sisters in a position to suffer "pecuniary loss as an immediate and proximate result of the old convent's destruction." They were in precisely the opposite position. Elimination of the old convent was the principal *quid pro quo* of the Bishop's obligation to build the Sisters a new convent. A premature accidental elimination of the building would relieve the Bishop of his collateral obligation to pay for its demolition, but certainly would not excuse him from performing his main obligation of

building the new convent. Thus, the Sisters could not suffer any pecuniary loss as a result of the fire, because the Bishop's binding obligation to build them a new convent would remain in force, and might even be performed by him earlier than otherwise scheduled.

A binding contract for demolition, such as the Sisters had entered into with the Bishop, is sufficient, in and of itself, to terminate the insurable interest of the party contractually committed to the demolition. In the recent case of *Leggio v. Miller Nat'l Ins. Co.*, 398 S.W.2d 607, 12 CCH Fire and Cas. Cases 1001 (Tex. Civ. App. 1965), the insured was the owner and lessor of a building under a lease giving the lessee an option to tear down the building provided he replaced it with an equal or better one. The parties disagreed as to whether the lessee had effectively exercised the option prior to the fire. The court stated that:

"if the option [to demolish] was effectively exercised and accepted before the fire, the insured *would no longer have any pecuniary interest in the existence of the building and would thus have no insurable interest.*" 398 S.W.2d at 610, 12 CCH Fire & Cas. Cases at 1003 (emphasis added).

The court decided for the insured on finding that "while both parties contemplated that the option would be exercised and had actually made some preparation for the demolition . . . prior to the fire, yet they had not gone far enough to reach a definite agreement." *Ibid.*

This case is free of the evidentiary complications that appeared in the *Leggio* case. There can be no doubt that the Sisters entered into a definite and unambiguous agreement for the old convent's demolition well before the fire. California insurance law, moreover, clearly incorporates the principle applied in the *Leggio* case that an insured does not have an insurable interest in property whose destruction will cause him no pecuniary loss and whose preservation gives him no pecuniary benefit. Accordingly, we submit that when plaintiff executed the Agreement of April 20, 1964, its insurable interest in the old convent came to an end.

Arguably, the Sisters did not lose all of their insurable interest in the old convent when the April 20, 1964 Agreement was executed, because of their continued use and occupancy of the old convent after that date. The insurable interest remaining in the Sisters under this theory would not afford them any right of substantial recovery in this action. The California cases, more fully discussed in Part II of this Argument, *infra*, at page 43, hold clearly that a policy of fire insurance does not insure a building, but only the interest of the insured in that building. Recovery under the policy, therefore, is allowable only to the extent of the interest of the insured. Once the April 20, 1964 Agreement was executed, the Sisters' remaining interest in the old building was, at the very most, a right of use and occupancy pending construction of the new convent by the Bishop. This, by implication, was to be accomplished within a reasonable time after execution of the Agreement. Calif. Civil Code § 1657. The extent of the Sisters' insurable interest in the building after April 20, 1964, would therefore be akin to that of a lessee having a given period of remaining occupancy under a lease, see *Sievers v. Union Assur. Soc'y*, 20 C.A. 250 (1912), discussed *infra* at pages 44-45, and the correlative measure of that interest would be the cost of equivalent substitute shelter for the reasonable period of time within which the Bishop was required to build and furnish the new convent.

C. THE BISHOP'S PERFORMANCE UNDER THE AGREEMENT EXTINGUISHED ANY REMAINING INSURABLE INTEREST OF PLAINTIFF.

Performance by the Bishop and others under the Agreement of April 20, 1964 erased any doubt that the Agreement had committed the old convent to destruction and extinguished plaintiff's insurable interest therein.

Following execution of the April 20, 1964 Agreement the Bishop began performance by contracting with the general contractor Garing for the new convent's construction and the site development work. Under the authority of his contract with the Bishop, Garing promptly subcontracted the old convent's demolition to Allen.

These demolition contracts were substantial acts in performance of the April 20, 1964 Agreement. They transmuted that Agreement from what the trial court chose to characterize as "a mere permission granted to the Bishop for the eventual razing of the old building" (R. 149) into a chain of obligations committing each of the four parties involved to the demolition of the old convent. The Bishop's contract with Garing, made in reliance upon his Agreement with the Sisters, strengthened his right to proceed with the old convent's demolition under that Agreement. Garing's rights under his contract with the Bishop were similarly augmented by virtue of his subcontract with Allen. "Where the plaintiff is not interested solely in profit . . . but must proceed with the work in order to fulfill contract obligations with others, . . . damages may be inadequate and the plaintiff may have a right to continue performance." *Bomberger v. McKelvey*, 35 Cal.2d 607, 614 (1950).

The Sisters were bound by the contracts among the Bishop, Garing and Allen as much as if they were parties thereto, or were directly responsible for the acts to be done thereunder. Because of their Agreement with the Bishop, they had no right or authority to interfere with either the formation or performance of these supplementary contracts. Any such interference by the Sisters would have violated the implied covenant of every agreement that neither party shall frustrate or interfere with the other's performance of a condition or obligation thereof. RESTATEMENT OF CONTRACTS § 315; 3 CORBIN ON CONTRACTS § 571 (1960); see *Gray v. Bekins*, 186 Cal. 389, 395 (1921).

The foregoing acts of performance by the Bishop and others, sufficient in themselves to make the Sisters' contractual obligation far more than "a mere [executory] permission," were soon succeeded by others that even more clearly established the lack of any remaining insurable interest in the Sisters at the time of the fire.

Prior to the fire, the new convent was completely constructed by the general contractor and was furnished for the Sisters' occupancy by the Bishop. An official notice of the building's completion as of May 18, 1966 was recorded by the Bishop. These develop-

ments accomplished two things of critical importance to the question of the Sisters' insurable interest in the old convent:

1. Any remaining possibility of a pecuniary interest in the building's preservation or a pecuniary loss from its destruction, based either on the Sisters' use and occupancy of the old convent up to that time or on the building's value as security for the Bishop's performance, was eliminated. A new convent, constructed and fully furnished by the Bishop, awaited the Sisters' occupancy.

2. The Sisters' contractual commitment to the demolition of the old convent became a fully-matured, present obligation, *prompt performance of which was due*, because its condition precedent under the Master Plan (the new convent's construction) had been fulfilled.

As previously noted, the Sisters possibly retained some insurable interest in the old convent after the demolition contracts were executed because of their continued use and occupancy of the old building. Obviously the completion of the new convent in a condition ready for the Sisters' occupancy nullified this basis of insurable interest.

Once the new convent was completed and ready for occupancy, the old convent also lost any earlier value it may have had as security for the Bishop's performance. The Bishop's next obligation under the Master Plan was to demolish the old convent and prepare the site for high school purposes. Far from securing that obligation, the old convent's remaining in place could only frustrate its performance. At this point, therefore, the building's preservation had no value, pecuniary or otherwise, to the Sisters, and its destruction could cause them no loss.

The Bishop's construction of the new convent was also the condition precedent of the Sisters' obligation to proceed with the old convent's demolition. Once this condition was met, the agreed sequence for the parties' joint performance of their Agreement was for the Sisters to surrender the old convent for demolition—a demolition that was in turn the condition precedent for the succeeding steps of performance. Thus the Sisters' commitment

to surrender the convent for demolition became a present, fully-matured obligation before the fire, and its prompt performance was due.

The evidence thus shows that at the time of the fire the Bishop and those acting for him had performed the April 20, 1964 Agreement as fully as it was possible for that Agreement to be performed until the Sisters surrendered the old convent for demolition. In performance of the Agreement, the Bishop had deeded the land he previously owned to the Sisters (Exh. Y) and had constructed a new convent thereon, all in the expectation that he would be allowed, reciprocally, to demolish the old convent and use the property for high school purposes. Such performance in reliance upon the Agreement clearly entitled the Bishop to insist on fulfillment of the Sisters' commitment to the old convent's demolition. See *Bomberger v. McKelvey*, 35 Cal.2d 607, 618-19 (1950).

D. THE SISTERS' PERFORMANCE UNDER THEIR AGREEMENT WITH THE BISHOP CONFIRMED THAT THEY HAD NO INSURABLE INTEREST IN THE OLD CONVENT AT THE TIME OF THE FIRE.

The Sisters did not in fact renounce their commitment to the old convent's demolition. Mother Thaddea testified that the Sisters never requested or directed the Bishop or anyone else not to proceed with the demolition as scheduled. Tr. 39-40.

On the contrary, the Sisters promptly performed their contractual obligation as soon as it became due. Prior to the fire, they moved into the new convent constructed by the Bishop, vacated the old convent, auctioned off the furniture and personal property remaining therein, and permitted the utilities to be disconnected by one of the contractors. They could not have more completely surrendered the convent for demolition. The Sisters' performance under their Agreement—the only performance relevant to any continuation of their interest in the building—was complete at the time of the fire. There was nothing more they could do to help accomplish the demolition of the building.

The transcript of the proceedings below and the trial court's opinion show that the court gave no significance to the Sisters' actual performance of the Agreement. Instead, the court considered it decisive that the subcontractor had not completed, nor substantially performed, the work of final demolition at the time of the fire. R. 149, 157; see Tr. 291-93. This consideration was irrelevant to the question of the Sisters' performance. Their performance, already complete, was not retroactively excused, modified, or discharged by the fact that total demolition of the convent was not accomplished by the time of the fire.

The evidence is undisputed that the Sisters had turned over possession of the building to the subcontractor who, through his agent, had begun the exercise of his salvage rights. The extent of his further progress toward demolishing the building was an adventitious circumstance, lacking in any factual or legal significance to the issue of plaintiff's insurable interest. This was underscored by the statement of Sister Mercedes the morning after the fire, when she told Gale, the insurance adjuster representing defendant, that the Sisters "had moved out and were comfortably established in their new home [and] had no use for the old building, it was either to be or was being demolished." Tr. 230. Moreover, the *Leggio* case discussed *supra* at p. 16 shows conclusively that there is no requirement for a building's physical demolition to be completed, or even started, where by virtue of the arrangements for demolition the insured has previously lost any basis of an insurable; i.e., pecuniary interest therein. In holding, to the contrary, that the Sisters had an insurable interest in the old convent "so long as it stood in place," R. 149, the court fell into fundamental error by treating the building, rather than the interest of the Sisters (which had ceased to exist), as the subject of the insurance. See Argument, Part II-E, *infra*, at pages 41-45.

E. THE PREMISES OF THE TRIAL COURT'S DECISION WERE UNSOUND.

1. Introduction.

The evidence showed that the Sisters had entered into a binding contract with the Bishop for the old convent's demolition. The

Bishop and the Sisters had fully performed this contract up to the point of the building's final demolition by a subcontractor and manifestly intended that the demolition be completed. In the face of this overwhelming evidence that the Sisters had lost any insurable interest they had in the building, the District Court concluded that the Sisters had such an interest to the full extent of the convent's "actual cash value" at the time of the fire. R. 148-150.

The trial court reached this conclusion by relying on irrelevant facts, hypothesis lacking any basis in fact, and legal principles that were not applicable. In the preceding section we discussed the trial court's misplaced emphasis on the subcontractor's not having completed the final demolition of the old convent at the time of the fire. We now turn to the other premises on which the court erroneously relied.

In its opinion the court emphasized the following considerations, which we will discuss in order: (1) that the Sisters did not formally transfer or assign their legal title to the old convent building by the April 20, 1964 Agreement, or otherwise, prior to the fire; (2) that the Sisters' Agreement with the Bishop for construction of the new convent and destruction of the old were a "collateral benefit" to the Sisters and therefore irrelevant to defendant's insurance obligation (citing *Hughes v. Potomac Ins. Co.*, 199 C.A.2d 239, 249-51 (1962)); and (3) that the convent "had an insurable potential use and value to the Sisters so long as it stood in place and in the event of change of arrangements with the Bishop for any reason" (citing *Bomberger v. McKelvey*, 35 Cal.2d 607, 613-14 (1950)). R. 149-150.

2. The Sisters' "Legal Title" to the Old Convent at the Time of the Fire Was Either Irrelevant or Nonexistent.

The trial court erroneously assigned well-nigh conclusive legal weight to the absence of a formal transfer of the Sisters' "legal title" to the old convent building prior to the fire. The definition of insurable interest adopted by the California courts and legislature plainly directs the courts' attention to the realities of the

situation, as expressed in the requirement that the insured have a pecuniary interest capable of causing him a pecuniary loss. There is no room under that definition for exorbitant emphasis upon technicalities such as "legal title" that bear no necessary relation to these realities.

In this case, the Sisters' legal title, if it did exist, was only marginally if at all relevant to their insurable interest. The testimony showed that the locus of "title" to the building had no significance. When asked whether the Sisters had any plans for the old convent other than to allow the Bishop to have it demolished, Mother Thaddea answered that the Sisters had none, because "we had already made an agreement with the Bishop." Tr. 41. If an "owner's" bundle of rights respecting his property is reduced by self-denying agreement, as it was in this case, to the single "right" of obtaining the physical destruction of the property without cost to himself, then his remaining "ownership," whether or not it be termed a "legal title," clearly is not a sufficient foundation for obtaining insurance *against* such destruction.

The trial court cited no authority for particularly emphasizing the absence of a formal transfer of legal title by the Sisters. By contrast, although the question was not raised directly in *Leggio v. Miller Nat'l Ins. Co.*, 398 S.W.2d 607, 12 CCH Fire & Cas. Cases 1001 (Tex. Civ. App. 1965), discussed *supra* at p. 16, the court's opinion in that case clearly implies that legal title, as such, is unimportant. There was no suggestion that the owner of the building in that case had divested himself of his legal title to the building; he had merely given the lessee an option to demolish it. Yet the court held that, if the option to demolish was effectively exercised and accepted prior to the fire, the owner's insurable interest had terminated as a result. See also *Sievers v. Union Assur. Soc'y*, 20 C.A. 250, discussed *infra* at pages 44-45.

Even if the location of legal title to the building was of some overall significance, the trial court was not justified by the evidence in concluding, solely from the absence of a formal transfer, that the Sisters retained their legal title to the old convent to the time of the fire.

The form of the April 20 Agreement did not suggest or require that there be an express transfer of title to the old convent building from the Sisters to the Bishop. Under the Agreement and the Master Plan the Sisters were to retain the real property on which the old building stood, to receive adjacent real property from the Bishop, and to own and operate in perpetuum a high school and a new convent on the conjoined parcels. The Bishop, on the other hand, was not to own any of the real property or any of the improvements to be constructed thereon.

The old convent played no part in the parties' plans for the future. At no time did they contemplate any future for the building except early demolition. In this context an express severance of the building from the real property remaining in the Sisters and a transfer to the Bishop for the relatively brief interim remaining before its demolition would certainly have seemed a useless formality, if the parties had even stopped to consider it.

But however superfluous was a formal passage of title to the Bishop, his exercise of powers equivalent to ownership and control of the building was essential to the Agreement and the Master Plan. Under the Agreement the Sisters committed themselves to a single course of action respecting both the building and the underlying real property. They agreed to use the real property, solely and in perpetuum, for a high school, not as a convent or for any other purpose, and specifically gave the Bishop the power to demolish the old building. The Bishop, exercising this power, not only contracted for the demolition itself, but disposed as well of the salvage rights to the building. This was uniquely an act of ownership with respect to the building, utterly inconsistent with any retention of "title" by the Sisters, and eloquently confirmed the parties' own understanding of their agreement.

The testimony of the Sisters in court likewise corroborated this understanding. Sister Mercedes referred throughout her testimony to "what the Bishop planned to do with the old convent," Tr. 165; see Tr. 168, 173, 175, and stated that "anything regarding the . . . new convent . . . and the demolition of the old convent was in the hands of the Bishop." Tr. 164-65.

In such circumstances the courts uniformly credit substance rather than form, and pinpoint the locus of ownership accordingly. The case of *Smith v. Jim Dandy Markets, Inc.*, 172 F.2d 616, 618 (9th Cir. 1949) offers a pertinent and persuasive precedent. There this Court, applying California law, affirmed a decision of the District Court that an agreement purporting on its face to transfer only certain equipment, fixtures and machinery, and the interests of the transferor under various leases, was properly construed to transfer in addition the ownership of a certain building, thereby depriving the transferor of an insurable interest in the building at the time of the fire. The agreement in that case did not even mention the insured building. Nevertheless, the court held that a transfer of ownership was consistent with the parties' intention to give the transferee complete control over the facilities by which it carried on its business, and was necessary because a reserved power of the transferor to remove the building would "plunge the [parties'] agreement into inconsistency and confusion."

The California Supreme Court held similarly in *Bomberger v. McKelvey*, 35 Cal. 2d 607, 618-19 (1950), that a demolition contract contemplating that title to the building would pass as the building was severed from the land was to be construed as if legal title had passed with the agreement because of the contractor's "right to specific performance of the agreement and thereby to acquire legal title."

In this case a transfer of rights equivalent to ownership of the old convent was clearly needed to give the Bishop the complete control he needed to carry out the parties' program of demolition and construction. If the Sisters had retained any color or semblance of right (however ill-founded in light of their Agreement) to interfere with the demolition of the building by the Bishop and the contractual arrangements which he had made, not only the Agreement of April 20, 1964, but the construction contract and the subcontract as well would have been plunged into "inconsistency and confusion."

Accordingly, we submit that the question of title was immaterial because all the incidents of ownership and possession were in the Bishop, subject to the salvage rights of the subcontractor, at the time of the fire. To the extent that the trial court based its finding of an insurable interest on the Sisters' "legal title," its decision was therefore in error.

3. The Sisters' Agreement Precluded Them from Suffering a Loss and Did Not Indemnify Them "Collaterally" for a Loss Already Suffered.

Referring to the case of *Hughes v. Potomac Ins. Co.*, 199 C.A. 2d 239, 249-51 (1962), the court stated that the Agreement between the Bishop and the Sisters for building the new convent and demolishing the insured building constituted a "collateral benefit" to the Sisters and was irrelevant to the insurance company's obligation.

The *Hughes* decision did not deal, as this case does, with the relevance of events occurring prior to any loss of the insured. In *Hughes* a landslide caused by heavy rainfalls dislodged a huge block of earth beneath the plaintiff's house, depriving it of subjacent and lateral support. Subsequently the Contra Costa County Flood Control District, at no cost to plaintiff, restored the damage and stabilized the soil, returning the property to its condition before the slide. The court held that the company could not take advantage of the Flood District's action to avoid its own liability since "an insurer is not entitled to the benefit of the fact that the insured's loss has been cured by the act of a third party, . . ."

The *Hughes* case and the various decisions cited therein deal with events occurring subsequent to the fire. For the courts in those cases to have determined the insurer's liability with reference to such events would have violated the cardinal principle that the existence of an insurable interest and the obligation of the company are to be determined as of the time of the loss. See *Greco v. Oregon Mut. Fire Ins. Co.*, 191 C.A.2d 674, 686 (1961); Calif. Ins. Code § 286.

Such cases of post-facto indemnification are not comparable in any respect to the present one, where the rights of the parties are based entirely on events occurring *before*, not after, the fire. The question in this case is not whether the Sisters' loss was "cured" or indemnified after it had occurred, but whether they suffered any pecuniary loss from the old convent's destruction in the first place. The evidence shows that they did not, for *before the fire occurred* the Bishop had built them a new convent which they were already occupying, thus obviating any possibility of a pecuniary loss from the old building's premature destruction.

4. There Was No Basis for the Court's Assumption of a "Change of Arrangements with the Bishop."

The trial court also concluded that "the building still had an insurable potential use and value to the Sisters so long as it stood in place and in the event of change of arrangements with the Bishop for any reason . . .", but it did not spell out any possible "change of arrangements" or explain its citation of *Bomberger v. McKelvey*, 35 Cal.2d 607, 613-14 (1950) at this point. To some extent the court's statement merely appears to reiterate its position that plaintiff's arrangements with the Bishop were irrelevant, for it went on to term a change in such arrangements as "a matter with which the defendant company would have no legal concern."

It would be more accurate to term such a "change of arrangements" as a matter with which none of the parties has any legal concern in this case. The evidence did not even hint at such a change. The testimony of the Sisters themselves showed affirmatively that no such change had ever been made, or even contemplated, to the time of the fire. Tr. 39-41. Consequently, the court's assumption of such a change was without any foundation in fact, and violated the principle that insurable interest is to be determined according to the facts and circumstances obtaining at the time of the fire, not on the basis of what may or may not happen at some time in the future.

The hypothesis of a possible modification of the parties' Agreement before the fire was inherently implausible, considering that no such modification had occurred to that time and that only a matter of days, if that much, remained before the building was totally demolished. Even the free exercise of imagination does not readily bring to mind any conceivable reason for the parties to modify their Agreement at this point, unless it be the far-fetched possibility of a sudden fire in the new convent that the court also offered in justification of its holding that the old convent had full cash value to the Sisters at the time of the fire. We deal with this conjectural basis of value at some length in Part II of this Argument and will not anticipate the discussion at this point, except to state that the improbability of such an hypothesis is not diminished by the frequency of its employment.

The purpose of the court's citation to *Bomberger v. McKelvey*, 35 Cal.2d 607, 613-14 (1950) in the context of a possible "change of arrangements" with the Bishop is somewhat difficult to discern. The *Bomberger* case held that a demolition contractor had the right to specific performance of a demolition contract giving him salvage rights to the building in question, and an irrevocable license to enter the defendant's land in order to perform his contract. There is nothing in the pages of that opinion cited by the trial court that lends any basis whatever to its assumed "change of arrangements," except for an introductory statement by the Supreme Court of the general rule that "either party to an executory contract has the power to stop performance of the contract by giving notice or direction to that effect, subjecting himself to liability for damages . . ." *Ibid.* The Supreme Court found that rule inapplicable to the Agreement before it in the *Bomberger* case. Here it was certainly inapplicable because, at the time of the fire, the Agreement of April 20, 1964, as it related to the old convent, was anything but an executory contract. Our analysis above shows that it had been substantially performed by both of the parties thereto, and that the Sisters' performance—the relevant performance—was complete. See pages 17-21, *supra*.

The question of possible breach of contract is, in any case, beside the point, because it is well established that the courts do not routinely speculate on whether parties will honor their contractual obligations and on what, if anything, the courts will do about it if they do not. Rather, the courts will always presume that parties enter into binding contractual obligations in good faith with the intention that they will be fully performed, not broken or modified by a "change of arrangements" detrimental to other parties holding related contract rights. *U.S. v. Maryland Cas. Co.*, 54 F.Supp. 290, 291 (W.D. La. 1944), *aff'd* 147 F.2d 423 (5th Cir. 1945); *Marine Midland Trust Co. v. Allegheny Corp.*, 28 F.Supp. 680, 683 (S.D.N.Y. 1939); Calif. Civil Code § 3545; see 1A CORBIN ON CONTRACTS §§ 182, 259 at p. 463-64 (1963). Here there was absolutely no basis in the evidence for departing from this presumption.

An analogous line of speculation was rejected in *Board of Educ. v. Hartford Fire Ins. Co.*, 124 W. Va. 163, 19 S.W.2d 448, 451 (1942), a decision we discuss more fully in Part II of this Argument, *infra*. There the plaintiff school board had entered into a binding contract for demolition of an insured school building and had given notice that it would surrender possession of the building for demolition on a date certain, a few days prior to which it was destroyed by fire. The court held that:

Until there is a showing indicating the contrary purpose, it may be supposed, as a matter of fact, that all enforceable contracts, particularly those of a public body, the members of which are presumed to properly discharge their public duty, will be substantially performed. True, if the board had been found guilty of improper conduct, the P.W.A. grant could have been withdrawn, but that withdrawal was only a future possibility, not an existing circumstance.

How much more forceful is the presumption of due performance in this case, where possession of the building had already been given to the subcontractor and the "change of arrangements" that the court envisioned would have required a retaking of such possession and not merely an anticipatory repudiation of the Sisters' Agreement.

F. THE COURT BELOW ERRED IN DECIDING THE ISSUE OF INSURABLE INTEREST IN SUMMARY PROCEEDINGS.

On motion of plaintiff for summary judgment, the court below determined before trial that plaintiff had title to, and an insurable interest in, the old convent on the date of the fire. R. 80. The court's order, as later modified on motion of defendant, R. 83, adjudicated *inter alia* as "facts not in controversy and duly established" that:

1. Plaintiff had an insurable interest in the old convent on the date of the fire (R. 81, ¶ 3);

2. Plaintiff had not assigned its title to, or interest in, the old convent or the real property on which it stood to the Roman Catholic Bishop of Oakland or to any other person as of the date of the fire (*Ibid*, ¶ 4);

3. Plaintiff's Agreement with the Bishop dated April 20, 1964, and the contracts for demolition of the old convent subsequently entered into by the Bishop and others acting for him, did not affect plaintiff's legal title to the old convent and the real property, or defeat plaintiff's insurable interest therein (*Ibid*, ¶ 5, 6);

4. The only issues remaining for adjudication at trial were: (a) plaintiff's compliance with the policy's terms and conditions; (b) the extent of physical damage to the building; and (c) the amount of damages, if any, to which plaintiff was entitled under the policy. (R. 83-84)

The final pretrial conference order, which governed the subsequent proceedings and the trial of the case, adopted as "facts not in controversy and . . . duly established" each and every point determined in the summary judgment proceedings. R. 85-87.

Summary adjudication of the insurable interest issue was clearly error. The finding that the Sisters had "legal title" to the old convent did not establish that the Sisters had an insurable interest in the building, as we have shown above at pages 22-26. That discussion also shows that the location of title to the old convent on the date of the fire was itself a fact that could not be determined summarily. Nor could the court determine the effect of the Sisters' Agreement with the Bishop and the related contracts for demoli-

tion without considering, in addition to the bare terms of the agreements, the conduct of the parties and the other surrounding factual circumstances. "[T]he construction placed upon the instrument by the parties themselves is persuasive; the law recognizes that the practical construction made by them is persuasive of what they intended." *E.g., Long Beach Drug Co. v. United Drug Co.*, 13 Cal.2d 158, 166-67 (1939); *U.S. v. Hensler*, 125 F. Supp. 887, 894 (S.D. Calif. 1954). Here the parties' performance under the agreements; *i.e.*, their practical construction, was of great importance to an assessment of the Sisters' position *vis-a-vis* the old convent on the date of the fire. See pages 17-21 *supra*. Yet the court determined the effect of these contracts by considering only their terms, thus treating them as if they were purely executory agreements.

The court further ignored the competing factual inferences drawn by the parties from the terms of the contracts, and limited its inquiry to whether the documents purported to accomplish a transfer or change of the Sisters' interest in the old convent in so many words. The conflicting inferences deducible from the agreements were properly to be examined in a trial at which the parties' intentions and understandings of the situation could be fully explored in oral testimony and cross-examination. *S. J. Groves & Sons Co. v. Ohio Turnpike Comm.*, 315 F.2d 235, 237-38 (6th Cir. 1963) *cert. denied* 357 U.S. 824 (1963); *American Fid. & Cas. Co., Inc. v. London & Edinburgh Ins. Co.*, 354 F.2d 214, 216 (4th Cir. 1965).

On this appeal, defendants' contentions as to the reasonable inferences from the agreements must be taken as true. *Entin v. City of Bristol*, 368 F.2d 695, 697 (2d Cir. 1966). Given the precedent of *Smith v. Jim Dandy Markets, Inc.*, 172 F.2d 616, 618 (9th Cir. 1949), discussed *supra* at page 25, it was hardly unreasonable for defendant to contend that the Sisters' Agreement with the Bishop, coupled with the Bishop's contracts concerning the old convent, should be construed to divest the Sisters of their insurable interest in the building. The court therefore erred in ruling summarily, before hearing the testimony of the

parties to any of the agreements, that those agreements and the acts done under them had no effect on the Sisters' insurable interest.

This error was not cured by the trial court's separate findings of fact and conclusions of law regarding insurable interest. The final pretrial conference order precluded defendant from litigating the question of insurable interest. Defendant understandably prepared and presented its case in acquiescence to this order. The trial court did not question or set aside the summary adjudication, and defendant was not given notice that the question would be reopened. The court merely overruled the objections of plaintiff's counsel to the admission of the Sisters' Agreement with the Bishop and to related testimonial and documentary evidence, all of which evidence was independently admissible on the question of plaintiff's damages. This procedure fell far short of guaranteeing to defendant the full day in court to which it was entitled on the question of insurable interest. It gave the court below a second chance to amplify and shore up the findings that had been made in the summary proceedings, without giving defendant a corresponding chance to dispute them.

G. SUMMARY OF DEFENDANT'S POSITION THAT PLAINTIFF HAD NO INSURABLE INTEREST ON THE DATE OF THE FIRE.

Defendant contends that the trial court erred in holding that plaintiff had an insurable interest in the old convent at the time of the fire. The crucial point is not whether plaintiff had "legal title" to the building, whether there might still have been a "change of arrangements" under plaintiff's binding Agreement for demolition, or whether the subcontractor had completed all of his demolition work at the time of the fire. The true question is whether, after determining to abandon the building, executing the Agreement authorizing the Bishop to contract for its demolition, moving into the new convent built and furnished for them by the Bishop, auctioning off the furnishings and fixtures in the old building, permitting the substantial removal of these fur-

nishings and fixtures and the disconnection of the building's utilities, vacating the old building, and turning over possession to the subcontractor for demolition, the Sisters had any pecuniary interest in the preservation of what was then left of the building. The evidence proved conclusively that they had no such interest, could not suffer a pecuniary loss from the "building's" destruction, and therefore had no insurable interest in the old convent.

II. The Proper Method for Determining "Actual Cash Value" Was the "Broad Evidence" Test Permitting Full Consideration of All Relevant Circumstances Affecting the Building's Value to the Insured.

A. CALIFORNIA LAW REQUIRES THAT THE DETERMINATION OF "ACTUAL CASH VALUE" BE PREDICATED ON THE PRINCIPLE OF INDEMNITY.

This case calls for interpretation of the phrase "actual cash value" as used in the standard form of fire insurance policy prescribed by Section 2071 of the California Insurance Code, and in the policy sued on by plaintiff.

The Code section and the policy involved in this case provide for insurance:

to the extent of the actual cash value of the property at the time of loss, but not exceeding the amount which it would cost to repair or replace the property with material of like kind and quality within a reasonable time after such loss, without allowance for any increased cost of repair or reconstruction by reason of any ordinance or law regulating construction or repair, . . . nor in any event for more than the interest of the insured,

Although California enacted the standard form of policy in 1949, the California courts have yet to prescribe any general rule for the determination of "actual cash value" thereunder. The absence of such a rule is confirmed by the authorities collecting interpretations of "actual cash value" from the courts of all states. Such authorities were relied on exclusively by the court below in prescribing replacement cost less depreciation as the measure of "actual cash value" in this case. R. 153. An examination of these authorities shows, however, that the only California

decision they refer to is that of the District Court of Appeal in *Hughes v. Potomac Ins. Co.*, 199 C.A.2d 239, 253 (1962), discussed in a different context *supra* at p. 26. That decision upholds the criterion of *market value*, in situations "where property is of such nature that its market value can be readily determined, . . ." Neither by expression nor implication does it uphold replacement cost (less depreciation) as the proper yardstick of "actual cash value" in California.

Since the California courts have not yet prescribed a method for determining the "actual cash value" of property that does not have a readily determinable market value, the question in this case is of first impression in California. The basic principles of California insurance law, to which we now turn, are of controlling importance in the resolution of this question.

The purpose of an insurance contract is "to indemnify another against loss, damage or liability . . ." Calif. Ins. Code § 22. "This [indemnity] principle underlies the contract, and it can never, without violence to its essence and spirit, be made by the assured a source of profit, its sole purpose being to guarantee against loss or damage . . . The very meaning of the term "indemnity" excludes all idea of profit to the insured." *Davis v. Phoenix Ins. Co.*, 111 Cal. 409, 415 (1896). It is a commandment that "the insured is entitled to recover . . . only such loss as he has actually sustained, . . ." *Whitney Estate Co. v. Northern Assur. Co. of London*, 155 Cal. 521, 524 (1909).

The cardinal principle of indemnity is carried into the law of damages by California Insurance Code, Section 284, declaring in pertinent part that:

[T]he measure of an insurable interest in property is the extent to which the insured might be damnified by loss or injury thereof.

It is also carried into Section 2071, the insuring clause of the standard form of policy that is to be interpreted in this case. This point was underscored in the recent case of *Breshears v. Indiana Lumbermens Mut. Ins. Co.*, 256 A.C.A. 265, 268 (1967),

where the lower court had held Section 2071 unconstitutional because it specifically excludes from "actual cash value" any costs of complying with ordinances regulating reconstruction or repair. The District Court of Appeal reversed, holding that:

The rationale of the decision completely ignores one of the traditional concepts of fire insurance which is to indemnify or compensate the insured for the actual loss which he has sustained and not necessarily to place him in a better position than he was in at the time of the fire.

In support of this statement the court cited *McAnarney v. Newark Fire Ins. Co.*, 247 N.Y. 176, 159 N.E. 902 (1928), a case that we will shortly consider.

B. THE "BROAD EVIDENCE" TEST OF ACTUAL CASH VALUE IS BEST SUITED TO THE ACHIEVEMENT OF INDEMNITY IN ALL CASES.

Courts and commentators have recognized for some time that use of an inflexible formula for determining "actual cash value" does not reliably assess the actual extent of an insured's loss in all cases. The kinds of property, the conditions and possibilities of its use, its relation to the insured, and other related circumstances are all too variable for the application of a fixed standard to result consistently in neither profit nor loss, but indemnity, to the insured.

Thus the traditional tests of market value and replacement cost (less depreciation), which once competed for supremacy, have increasingly been discarded as exclusive indices of actual cash value, notably in states which hold to the indemnity theory of insurance contracts. *E.g.*, *Eagle Fire Co. v. Snyder*, 392 F.2d 570, 571 (10th Cir. 1968) (Oklahoma law); *Lampe Market Co. v. Alliance Ins. Co.*, 71 S.D. 120, 22 N.W.2d 427, 428-29 (1946); *Grantham v. Farmers Mut. Ins. Co.*, 174 Neb. 790, 119 N.W.2d 519, 521-22 (1963); *Pinet v. New Hampshire Fire Ins. Co.*, 100 N.H. 346, 126 A.2d 262 (1956). In place of these rigid formulae, the courts have adopted a more inclusive and flexible test of "actual cash value" known as the "broad evidence rule. See 61 A.L.R.2d 718; 15 COUCH ON INSURANCE 2d

§ 54.137 (1966). This rule requires that the trier of fact consider all evidence which logically tends to a correct estimate of "actual cash value" for the property in question.

The origins and justification of this rule are lucidly stated in the *Pinet* opinion:

[W]e are impressed with what might be denominated a third rule which has received support in New York, Massachusetts and South Dakota, In these jurisdictions neither market value nor replacement cost is an exclusive test. Evidence of both market value and replacement cost with depreciation may be introduced as evidence of actual cash value. These jurisdictions stress the fact that variations in the types of property and the conditions under which they are destroyed prevent the adoption of any single test for all cases. The objective in these cases is to see that the insured should incur neither economic gain nor loss if he is adequately insured and suffers partial fire loss

In adopting this third rule in this state, which has worked successfully elsewhere, we are fortified by the authoritative conclusions of Bonbright and Katz, *Valuation of Property to Measure Fire Insurance Losses*, 29 Col.L.Rev. 857, 899. *'In general we conclude that the opinions of the courts, especially of the appellate courts, have shown an increasing desire to make the measure of recovery for fire insurance losses correspond to the actual loss sustained by the insured in view of all the circumstances of the case. To put the matter in other words, the courts, when faced with a choice between applying some standardized rigid rule such as replacement cost minus physical depreciation or of adopting some more flexible test which can be modified in such a way as to accord more nearly with the principle of indemnity, have generally preferred the latter alternative even though it has involved the sacrifice of administrative convenience and of simplicity.'* 126 A.2d at 265. (Emphasis added.)

The spearhead of the movement away from the stereotyped approaches to "actual cash value" was the decision of the New York Court of Appeals in *McAnarney v. Newark Fire Ins. Co.*, 247 N.Y. 176, 159 N.E. 902 (1928). There the court was con-

cerned with the New York standard form of fire insurance policy, providing for payment of "actual cash value" in terms identical to those of the policy in this case. The insured building had been designed and once used for manufacturing malt, but was not employed for any purpose at the time of the fire because of passage of the Volstead Act. The New York Court of Appeals found that the market value test was not appropriate because the building had no ready market, and held that the building's replacement cost was an equally improper measure of its actual cash value:

We do not agree with the plaintiff that, under the standard clause, the sole measure of damage was cost of reproduction less physical depreciation. The words 'not exceeding the amount which it would cost to repair or replace the same with material of like kind and quality within a reasonable time after such loss or damage,' afford no remedy to the assured. *They merely express a privilege granted to the insurer This provision, while it doubtless comprehends cost of reproduction does not restrict the field of investigation to such cost or provide that, with depreciation, it shall constitute an exclusive measure of recovery.* 159 N.E. at 904. (Emphasis added.)

The court then formulated its "broad evidence" test of "actual cash value" in these terms:

Indemnity is the basis and foundation of all insurance law To insure is 'to guarantee or secure indemnity for future loss or damage.' . . . Where insured buildings have been destroyed, the trier of fact may, and should, call to its aid, in order to effectuate complete indemnity, every fact and circumstance which would logically tend to the formation of a correct estimate of the loss. It may consider original cost and cost of reproduction; the opinions upon value given by qualified witnesses; the declarations against interest which may have been made by the assured; the gainful uses to which the buildings might have been put; as well as any other fact reasonably tending to throw light upon the subject. 159 N.E. at 905.

The *McAnarney* decision thus makes explicit that the doctrinal underpinning of the "broad evidence rule" is the principle of indemnity; its objective is "to see that the insured should incur neither economic gain nor loss." *Pinet v. New Hampshire Fire Ins. Co.*, quoted *supra*, at page 36.

C. IN THE ABSENCE OF A CONTROLLING CALIFORNIA DECISION THE TRIAL COURT WAS OBLIGED BY THE PRINCIPLES OF CALIFORNIA INSURANCE LAW TO ADOPT THE BROAD EVIDENCE TEST AS THE METHOD MOST LIKELY TO ACHIEVE INDEMNITY.

The federal courts have frequently applied the broad evidence test to determine "actual cash value" since the test was first formulated by the New York Court of Appeal. *E.g.*, *Eagle Fire Co. v. Snyder*, *supra*, 392 F.2d 570; *Nebraska Drillers, Inc. v. Westchester Fire Ins. Co.*, 123 F. Supp. 678, 681 (D. Colo. 1954); *Wisconsin Screw Co. v. Fireman's Fund Ins. Co.*, 193 F. Supp. 96, 113-115 (E.D. Wis. 1961), *aff'd* 297 F.2d 697, 699-701 (7th Cir. 1962); *Harper v. Penn Mut. Fire Ins. Co.*, 199 F. Supp. 663, 664-65 (E.D. Va. 1961); see *Thorp v. American Aviation & Gen'l Ins. Co.*, 212 F.2d 821, 825 n. 5 and 7 (3rd Cir. 1954).

More importantly, the federal courts have consistently selected the broad evidence test to apply in cases where state law does not offer authoritative guidance on the question.

In *Harper v. Penn. Mut. Fire Ins. Co.*, *supra*, the District Court held that:

In the absence of a controlling Virginia decision, this Court adopts the broad evidence rule, as strict adherence to either of the recognized tests of 'market value' or 'reproduction cost less depreciation' will merely serve to shackle the trier of fact in all cases. 199 F. Supp. at 664.

The Court's reason for rejecting the replacement cost test was of particular relevance to the facts of this case:

To adopt the 'reproduction or replacement cost, less depreciation' theory may well result in an inflated value, particularly where the specialized use of property has been abandoned or otherwise modified. *Id.* at 665.

In *Thorp v. American Aviation & Gen'l Ins. Co.*, *supra*, "the difficulty presented itself that . . . research had failed to disclose a New Jersey decision defining the standard of proof establishing 'actual cash value.' Under the circumstances the trial judge was constrained to resort to general applicable principles to reach a conclusion consistent with New Jersey law." 212 F.2d at 825 n.5. The trial judge did so, and charged the jury in terms quoted almost *verbatim* from the *McAnarney* opinion. The Third Circuit affirmed this charge.

Finally, in *Wisconsin Screw v. Fireman's Fund Ins. Co.*, *supra*, the District Court made an intensive review of the authorities and concluded that:

[T]he Supreme Court of Wisconsin, were it called upon to define those factors for the first time, would, as did the Supreme Court of New Hampshire in the Pinet case, note that the recent opinions of the courts, especially of the appellate courts have adopted the 'broad evidence rule' of the *McAnarney* case as *the method most likely to effectuate indemnity*. 193 F. Supp. at 115. (Emphasis added.)

The Seventh Circuit approved and affirmed this holding.

These decisions show that it was the duty of the trial court to resort to general applicable principles to reach a conclusion consistent with California law. *Thorp v. American Aviation & Gen'l Ins. Co.*, *supra*. This the court could not do without recognizing that the principle of indemnity is paramount in the insurance law of California. See Part II-A, *supra*, at pages 33-35. Accordingly, it was the trial court's clear obligation to adopt the broad evidence rule as "the method most likely to effectuate indemnity," *Wisconsin Screw Co. v. Fireman's Fund Ins. Co.*, *supra*, and least likely to result in an inflated value. *Harper v. Penn. Mut. Fire Ins. Co.*, *supra*.

D. THE TRIAL COURT ERRED IN REJECTING THE BROAD EVIDENCE TEST AND ADOPTING REPLACEMENT COST AS THE SOLE MEASURE OF "ACTUAL CASH VALUE."

The trial court paid lip service to the *McAnarney* decision in its opinion, and even agreed during argument that there were three

possible tests for determining actual cash value. Tr. 343. But in considering the evidence and arriving at judgment, the court relied exclusively on evidence of the building's replacement cost (less depreciation) to determine actual cash value and formulated its rule of law accordingly.

The court conceded in its opinion that the phrase "cost to repair or replace" as used in Section 2071 is "more of a limitation on the insurer's liability than a substantive measure of damages", and that "the real substantive measure of damages is 'actual cash value'." R. 152. The court declined to credit its own careful distinction, however, for its holding was that:

"The measure of recovery for a building loss is the value of the building as it stood on the day it was destroyed, taking into consideration the cost of rebuilding or repair and allowing for the difference in value between a new building and the condition of the building just before the fire." (R. 153).

As authority for this statement the court cited only general treatises, none of which refers to any decisions by California courts adopting such a measure of recovery under § 2071 of the Insurance Code. Indeed, these same treatises could as well be cited to favor application of the broad evidence test. See 45 C.J.S., INSURANCE § 915, p. 1012 at n. 48-54; 61 A.L.R. 2d 711, 718-19, 729-32.

In concluding that the building had an "actual cash value" of \$226,000 at the time of the fire, the court relied expressly on the testimony of plaintiff's two appraiser witnesses, (R. 153), who, in the court's words, "only took into consideration the classic factors—replacement cost, depreciate it, period. They took nothing else into consideration whatsoever." (Tr. 353.) Conversely, the Court disregarded the testimony of defendant's appraiser concerning the adverse effect on the building's value of the substantial costs of conforming it to the Code, on the ground that "the witness did not even consider the cost of replacement of the building to its condition as it stood just before the fire." R. 154.

Although the trial court admitted the evidence offered by defendant on the question of value, the court's opinion shows that

it excluded all of such evidence from consideration in its determination of the property's actual cash value. Defendant's position, as stated by the court, was that the "arrangements between the Sisters and the Bishop . . . *should be considered* . . ." R. 155. (emphasis added). After stating this position, the court rejected it. R. 155-59. Similarly, the court recognized that the lower court error rectified in the *McAnarney* decision was "to *exclude consideration of* the unusefulness and obsolescence of a building . . ." R. 155. After so epitomizing the case, the court distinguished and rejected it as authority. R. 155-57.

These excerpts show that the court did not consider defendant's evidence and then deny it effect because of a lack of credibility, probative value or some other defect. Rather, the court did not consider the evidence at all because the evidence was irrelevant under the rule that the court adopted, erroneously, as the sole measure of recovery. The effect was as if the court had permitted all of the evidence to go to a jury, and then instructed the jury to consider nothing other than the evidence of replacement cost and depreciation in determining the amount of recovery. Such an instruction would be reversible error as clearly violating the letter and spirit of the broad evidence test. See *Sebring v. Fireman's Ins. Co.*, 237 N.Y.S. 120, 122; (App. Div. 1929); *Grantham v. Farmers Mut. Ins. Co.*, 174 Neb. 790, 119 N.W. 2d 519, 521-22 (1963). The court's analogous error in this case was no less reversible for the jury's absence.

E. THE DECISION IN LAURENT V. CHATHAM FIRE INS. CO. RELIED ON BY THE TRIAL COURT IS INCOMPATIBLE WITH THE LAW OF CALIFORNIA.

In rejecting the *McAnarney* decision as authority, the trial court relied on *Laurent v. Chatham Fire Ins. Co.*, 1 N.Y. Super. 45 (1 Hall 41) (1828), a case decided exactly one hundred years before the *McAnarney* decision by a New York City court of general jurisdiction, sitting at appellate term. Thus the trial court "distinguished" the *McAnarney* case on the basis of a decision that, if inconsistent with *McAnarney*, was necessarily overruled by it under the laws of New York.

In relying on the *Laurent* decision, the court misapplied not only the law of New York but, more to the point, the law of California as well. The trial court should have disregarded the *Laurent* decision because it is based on a fallacy that the California courts have criticized and rooted out of the law of this state. Furthermore, in a closely related factual situation, the California courts reached an opposite result by applying the principle of indemnity as it is understood in California rather than as it was erroneously applied in *Laurent*.

In the *Laurent* case the insured owned a building situated on land to which he held a lease with only 15 days of the term remaining at the time of the fire. The lease had an option to renew, but prior to the fire the insured had not given the required notice or otherwise signified his intention to renew the lease. The defendant contended that, because of the lease and the facts as they stood at the time of the fire, the insured should receive only the value of the building for the purpose of removal. The court rejected this contention, stating:

The judge ruled that the intrinsic value of the building at the time was the true measure of the loss within the meaning of the contract of indemnity, and we concur with him in that opinion.

* * *

It is the true and actual value of the tenement itself at the time, independently of its location, or the insecurity of the title or terms by which it is held, that the insurers agree to make good to the present proprietor in case the loss or damage by fire happens during the continuance of his ownership, and within the term of the insurance. It is of no importance whether the tenement stands upon freehold or upon leasehold ground, or whether the lease is about expiring or has the full time to run, when the fire occurs, or whether it is renewable or not. The condition of the policy is satisfied if the title and ownership are in the insured at the time of the insurance, and at the time of the loss, and the measure of his indemnity is the amount of his interest in the tenement when destroyed by fire, notwithstanding that the whole interest would have expired the very next day, or soon after the loss occurred. 1 N.Y. Super. at 54, 56.

It is plain that the *Laurent* court conceived of insurance as an indemnity guaranteeing to the insured the "intrinsic value" of a building or other object. The opinion of the court below echoes this viewpoint, stating that "indemnity to the insured . . . should not be made to depend upon the special and peculiar circumstances of the insured, e.g., . . . his contracts with others concerning it . . . as distinguished from the intrinsic value of the building at the time of loss." R. 155.

From the time of its early decision in *Davis v. Phoenix Ins. Co.*, 111 Cal. 409 (1896) to the present day, the California Supreme Court has consistently pointed out the fallacy on which the above viewpoint is based, and has held that the measure of indemnity under an insurance contract is not the intrinsic or absolute value of some object, but the pecuniary value of the insured's interest with respect to that object. In the *Davis* case, the Supreme Court had this to say:

In common parlance, we speak of a house as being insured, but, strictly speaking, it is not the house but the interest of the owner therein that is insured, and, whether that interest is founded upon a legal title, an equitable title, a lien, or such other lawful interest therein as will produce a direct and certain pecuniary loss to the insured by its destruction, he has an insurable interest therein. 111 Cal. at 414.

Many years later, in *Alexander v. Security-First National Bank*, 7 Cal.2d 718, 723 (1936), the Court reaffirmed these principles:

Although it is frequently said that the property is insured, this is inaccurate. The policy is not an insurance of the specific thing without regard to the ownership, but is a *special agreement of indemnity with the person insuring against such loss or damage as he may sustain*. (Emphasis added).

The concept of insurance indemnity embodied in these cases remains the cornerstone of California insurance law to this day:

It is a principle of long standing that a policy of fire insurance does not insure the property covered thereby, but is a personal contract indemnifying the insured against loss resulting from the destruction of or damage to his interest in that property. *Russell v. Williams*, 58 Cal.2d 487, 490 (1962).

This principle is concisely expressed in the standard policy provision for payment of "actual cash value," which directs that such payment shall in no event be "for more than the interest of the insured." Calif. Ins. Code § 2071, ¶ 1.

As these authorities show, the determination "of such loss or damage as [the insured] may sustain" is not a determination of a building's "intrinsic value." Nor is it a determination of its value "as a building." Cf. R. 155. It is an inquiry into its *actual cash value to the insured*—an inquiry that cannot sensibly proceed without a careful consideration of the insured's relevant contracts with others limiting the life of the building or the uses to which it can be put. These undeniably are facts that "logically tend to the formation of a correct estimate of such loss or damage as the insured may sustain." "'Actual' cash value will not be arrived at by ignoring such realities." *Lampe Market Co. v. Alliance Ins. Co.*, 71 S.D. 120; 22 N.W.2d 427, 428-29 (1946).

The above tenets of California law were decisive in *Sievers v. Union Assur. Soc'y*, 20 C.A. 250 (1912), a classic factual situation for applying the *Laurent* decision and its principles, but a case in which the District Court of Appeal decisively rejected such an application. The plaintiff, as in the *Laurent* case, was the owner of a building on leased ground under a lease having a full year, not a mere fifteen days, to run at the time of the fire. The lease contained no privilege of renewal and provided that the building would revert to and become the property of the lessor at its termination. Under the *Laurent* case the insured would have been entitled to the "intrinsic value" of the building as the measure of his indemnity for its loss. The insured's "title and ownership" would have been conclusive, and the ground lease and its provisions would have been wholly irrelevant as a collateral contract with another. It would have been "of no importance whether the [building stood] upon freehold or upon leasehold ground, or whether the lease is about expiring or has the full time to run, . . . or whether it is renewable or not." *Laurent v. Chatham Fire Ins. Co. supra*, 1 N.Y. Super. at 56.

The California District Court of Appeal refused to determine the extent of the insured's damages in the factual vacuum that the *Laurent* case would have created. Instead, the Court found that the insured's monthly profit from leasing the building was \$50 and limited the damages to the \$600 he would have received as such profit during the remaining term of the ground lease. As might be expected, the Court stated that "the question was decided in the case of *Davis v. Phoenix Ins. Co.*," and referred to the portions of the Supreme Court's opinion in that case that we have quoted above. See page 43, *supra*.

The trial court therefore erred in refusing to apply the *McAnarney* case on the authority of a much older decision of a lower court that is demonstrably out of harmony with the law of California. In so doing, the Court reached a result that is incompatible with the insurance law of California and therefore may not stand.

F. PROPERLY EVALUATED UNDER THE BROAD EVIDENCE RULE, THE FACTS REQUIRED THE CONCLUSION THAT THE BUILDING HAD NO SUBSTANTIAL "ACTUAL CASH VALUE" TO PLAINTIFF AT THE TIME OF THE FIRE.

Had the trial court considered all of the evidence rather than the mere fragment that its erroneous measure of damages permitted, it could not have found any substantial basis therein for its award of \$174,000 to the plaintiff.

Under the broad evidence test, one of the circumstances for the trial court to consider was "the gainful uses to which the building might have been put." *McAnarney v. Newark Fire Ins. Co.*, quoted *supra* at page 37. The evidence showed that no such use of the building remained at the time of the fire. The Sisters had agreed that the property on which the building stood would be used exclusively for high school purposes in the future and that the building would be demolished. The time for performance of their Agreement had arrived when the fire occurred and, in fact, they had already performed it by making the building available for demolition. From that point they had only to refrain

from interfering with the completion of the building's demolition by others, as their contract obliged them to and as they in fact were doing at the time of the fire.

Furthermore, what was left of the building was uninhabitable. Its plumbing and sewage system had been disrupted by the removal of pipes and fixtures. It therefore had no operable facilities for water supply or waste disposal. Its electrical system was not only disconnected, but immobilized by the removal of panels and fixtures. The expense of restoring these vital components of the building was only partly, if at all, included in the sizable outlay that was necessary, at all events, to bring the building to Code.

In determining the building's value to the insured, the court was obliged also to consider its age and condition under the *McAnarney* rule. *Ibid.* The evidence in this respect showed that the building was 90 years old and in such a state of disrepair and decrepitude that the City Building Inspector had found it to be a "fire hazard unfit for human occupancy," and that the City Building Department would not have permitted the Sisters to reoccupy it after once vacating it unless it were brought up to Code. The Sisters themselves had despaired of maintaining the building and for that reason had obtained the Bishop's agreement to build them a new convent, an agreement he had duly performed. The old convent's dilapidation and obsolescence were so extensive that, in the estimate of two witnesses, an expenditure of approximately \$121,000 would have been necessary just to conform it to the Building Code, without redeeming much of its structural and functional inadequacy which did not violate the Code. Finally, it had been stripped prior to the fire of *building fixtures* that the trial court found to have a value of \$52,000, almost $\frac{1}{4}$ of the amount it assigned as the "actual cash value" of the building.

In addition, the court should have considered the declarations against interest by the insured. *Ibid.* Here the evidence showed that the Sisters thought the building too expensive to maintain and that, after the fire, the Sister Superior in charge of the convent declared that the Sisters had no use for the old convent, that

they had moved into a new convent and that the old building was either to be or was being demolished. These statements were repeated in substance at the trial. Moreover, they were abundantly confirmed by the Sisters' actions in selling off building fixtures amounting to a substantial portion of its value under plaintiff's own standard of measurement, and in vacating the building and leaving it to its fate of demolition by the subcontractor.

Finally, the court was to consider the opinions of qualified witnesses as to the value of the building, *ibid.*, without regard to whether or not these opinions specifically considered its cost of replacement. Indeed, under the *McAnarney* rule, opinions based on a broad spectrum of the evidence in the case were decidedly to be preferred to those which, in the court's own evaluation, "took nothing else into consideration whatsoever." The witness Horton, whose qualifications were not questioned, took all of the above evidence and more into consideration and concluded that the building's "actual cash value" to the insured was negative, or nonexistent, primarily because of the exorbitant and largely nonproductive expenditure required before it could be used for any purpose. See pages 9-10 *supra*. The witness Gilbertson, who also qualified without question, confirmed the amount of this required preliminary expenditure. See page 10 *supra*.

All this evidence showed overwhelmingly that the building had no substantial actual cash value to the Sisters at the time of the fire, yet the court gave it no consideration in arriving at its decision and judgment. Instead of summoning the facts in evidence to its aid, as the broad evidence test demanded, the court elected to rely on speculation.

The trial court superimposed upon the facts in evidence the purely hypothetical notion of "a potential use" and an "insurable interest which would have proved quite important and valuable to the Sisters if the new convent had burned before actual demolition of the old one and the Sisters had been forced to return to it." R. 157. This theory on which the court placed its ultimate reliance expressed at best "only a future possibility, not an existing circumstance," *Board of Education v. Hartford Fire Ins. Co.*, 124

W. Va. 163, 19 S.E. 2d 448, 451 (1942), and was, less charitably, "a metaphysical hypothesis upon which to justify a loss that is no loss." *Leggio v. Miller Nat'l Ins. Co.*, 398 S.W.2d 610 (1965). The court's projection of such a hypothesis clearly transgressed the fundamental rule that both insurable interest and the actual cash value of such an interest are to be determined "at the time of loss" and on the basis of the circumstances which then obtain. Calif. Ins. Code § 2071, ¶ 1; 15 COUCH ON INSURANCE 2d § 54.82 (1966).

Even as hypothesis the court's theory lacked even a particle of plausibility. The odds of a destructive fire occurring in the newly-constructed convent in the period of days remaining before full demolition of the old convent were surely astronomical. Even if such a theoretical possibility were an admissible basis for attributing some lingering actual value to the old convent, that value would have to be discounted to the vanishing point in any realistic appraisal because of the improbability of such an occurrence. Moreover, the value of plaintiff's right to reoccupy the old building would be strictly limited according to the period of such reoccupancy, under *Sievers v. Union Assur. Soc'y*, *supra*.

The court's conclusion that the Sisters would have returned to the old building in the event of a fire in the new convent was itself a *non sequitur*. The only evidence on such a hypothetical reoccupancy showed that it would have been a practical impossibility, and contrary to law as well. The "building" had no functioning plumbing, waste disposal or electrical systems. These systems could not have been restored without major and costly repairs. Furthermore, Building Inspector Shobring's undisputed testimony established that once the Sisters moved out of the old convent, as they concededly did, the Berkeley Building Department would not have permitted them to reoccupy the building without bringing it into conformity with the Code. The testimony of witness Horton, again undisputed, was that the cost of so conforming the building was \$121,000, an amount exceeding 50 per cent of the building's "value", even as determined by plaintiff's experts. This value had already been reduced by almost 25

per cent by the removal of the \$52,000 in fixtures that the court deducted on the basis of testimony that was again undisputed. Thus at the time of the fire the old convent was in such condition that the reoccupation relied on by the trial court would have required an immediate expenditure of well over 50 per cent of the value that plaintiff claimed for the building.

It is inconceivable that the Sisters would have undertaken an expenditure of this size to reoccupy temporarily a building they had already abandoned because it was too expensive to maintain. The sheer incredibility of such an outlay, which defendant would have no obligation to finance, California Ins. Code § 2071; *Breshears v. Indiana Lumbermen's Mut. Ins. Co.*, 256 C.A.2d 265 (1968), is magnified by the virtual certainty that the new convent was itself fully covered by insurance. If that building had suffered a fire in its then undepreciated state, such insurance would have financed its complete reconstruction, very probably in less time than the Code work and major repairs to the old convent would have required. To ask the question whether the Sisters would have elected to obtain a temporary residence pending rebuilding of the new convent with the insurance company's money, or would have obtained such a residence for about the same length of time pending rehabilitation of the old convent with \$120,000 to \$170,000 of their own money, is to answer it. Thus, even as an abstract possibility, the court's theory of value suffered from a fatal lack of verisimilitude.

Instead of relying upon such a speculative proposition the trial court should have evaluated the evidence before it in light of the decision in *Board of Educ. v. Hartford Fire Ins. Co.*, 124 W. Va. 163, 19 S.E. 2d 448 (1942), a case which it cited in its opinion and sought unsuccessfully to distinguish.

The *Board of Education v. Hartford* case presented for determination the value of an insured school building that the plaintiff Board had decided to replace with a new building to be erected on the same site. The Board entered into a contract for demolition of the old building and construction of the new one, the contractor being permitted to use materials from the old building,

except for desks, heating appliances, etc., in constructing the new school. The Board notified the Public Works Administration, which was helping to finance the project, that work had begun on January 1 (at about which time certain preliminary surveys had been made by the contractor) and notified the contractor it would surrender possession of the old building on January 23. The Board then rented temporary quarters, moved its own office equipment out of the old building, unbolted the schoolroom desks therein, dismissed classes in the old building on January 18 and announced that they would reconvene January 23 in the rented quarters. On January 20, the building burned.

At trial the school board claimed a value of \$20,363.00 for the burned building, which the insurer resisted. The only issue tried, as the court's opinion makes clear, was the effect to be given the facts stated above in determining the building's value at the time of the fire:

[T]he only issue . . . concerned whether the building . . . was to be valued as a building for the purpose of arriving at its actual cash value, less depreciation, or was to be treated simply as a collection of material, the use of which as a building had terminated, and hence the cost of construction was not to be considered in arriving at that value. 19 S.E. 2d at 448.

The trial court, sitting without a jury, found the school board's damages to be \$8,344.38 and entered judgment in that amount.

In affirming this decision, the West Virginia Supreme Court held that:

[I]t seems quite apparent that if the settled policy of the board of education, that it was legally bound to execute and the performance of which it had definitely entered upon, by the acts of the board itself had eliminated the possible use of the New Cumberland School as a building, they should not be indemnified against its loss to the extent of being paid by insurer its actual going value. *Id.* at 450.

The judgment of \$8,344.38 affirmed in the *Hartford* case represented the value of the old school "as a collection of material,

the use of which as a building had terminated. . . ." 19 S.E. 2d at 448. This is implicit in the opinion, because the court first stated in framing the issue for decision that "if [the school's] value as a building had actually been permanently terminated, the recovery is limited to salvage value," *id.* at 449, and then held in conclusion "that the board of education prior to January 20, 1938, had permanently stopped using the New Cumberland School building for its intended purpose, and had begun the physical work of its removal." *Id.* at 451.

A salvage value of about \$8,300.00 for the materials in the old building in *Hartford* was consistent with the fact that these materials, with some exceptions, were to be used by the contractor in the new building. Presumably the school board had obtained a value commensurate with that of the materials in the form of a lower contract price, a benefit of which it would have been deprived if no damages had been allowed. By awarding the sum it did the court gave indemnification, without profit or loss, to the assured.

In this case it is even clearer "that the Sisters prior to June 8, 1966, had permanently stopped using the St. Joseph's Convent for its intended purpose, and had begun the physical work of its removal." The Sisters had surrendered the old convent for demolition, whereas in the *Hartford* case it was undisputed that surrender was not to take place until three days after the fire. So, too, the Sisters had vacated the old building and taken up full occupancy in new quarters, whereas the insured in *Hartford* was at most in a state of transition, having left unbolted school desks in the old building and not yet begun to hold classes in its temporary quarters. Moreover, in this case the work of final demolition had begun, whereas in *Hartford* it was clear and undisputed that only preliminary work had been done. Indeed, the *Hartford* case is direct authority that there is no requirement of "actual demolition," as supposed by the trial court, see R. 157, where the physical work of removal has begun.

Under the broad evidence test and the *Hartford* decision, the only conclusion that could validly be drawn from the evidence in this case was that the old convent had no substantial actual cash value to plaintiff. The evidence did not establish the value of the old convent as "a collection of material, the use of which as a building had terminated". See Tr. 204-07. The evidence did show, however, that a substantial portion of the building's fixtures were removed before the fire and that the Sisters had endeavored to sell or remove everything of value. Under these circumstances, the value of the old convent's remaining materials could not have approached even a significant fraction of the value of \$174,000 that the court assigned to it "as a building".

The trial court attempted to distinguish the *Hartford* case so as to justify its hypothesis of a fire in the new convent, previously discussed. The court noted that in this case "the new convent was to be built on adjacent land, not on the old site, as in *Board of Education v. Hartford*." R. 157. This was a distinction, not a difference. The court in *Hartford* in no way relied on the fact that the new school was to be built on the site of the old, nor gave it any significance whatever. Our analysis and comparison of the two cases above shows that, if anything, the Sisters were better off than the school board in *Hartford*. At the time of the fire they had a fully furnished and occupable convent, functionally and structurally superior to its predecessor, whereas the school board in *Hartford* had only "rented quarters," possibly ill-adapted to its use.

This supposed ground of distinction lent no credence or justification to the trial court's hypothesis of a second fire in the new convent. The court in *Hartford* might have supposed with equal abandon a fire in the rented quarters before demolition of the old school, and a consequent reoccupation of the old building until new rental quarters could be found. Although counsel's ingenuity was not sufficiently acute as to afford the *Hartford* court that opportunity, the court was presented with a suggestion that "if the board had been found guilty of improper conduct, the P.W.A. grant could have been withdrawn," (*id.* at 451) and the

contract not performed. The court's refusal to indulge in such a baseless presumption was an example the trial court should properly have followed in this case, all the more compellingly because the hypothesis of a second fire was not only speculation in itself, but was offered to support an inference of reoccupancy that the evidence already contradicted.

The trial court also portrayed the *Hartford* case as upholding rather than denying the application of *Laurent v. Chatham*. In support of this interpretation the trial court quoted a portion of the West Virginia Supreme Court's opinion in *Hartford* which, after discussing the *McAnarney* case, *Laurent v. Chatham* and several other cases also cited by the court below (see Part II-G, *infra*), stated that:

We wish to state quite frankly that we do not approve of a general rule that would permit speculative, collateral questions, including the intended destruction, to enter into the ascertainment of *actual* value. In our judgment, such a principle would multiply litigation and unnecessarily complicate insurance adjustments. 19 S.E. 2d at 450. (Emphasis in original.)

Immediately after this statement in the *Hartford* opinion, however, there appears the court's statement of the rule of decision for the case before it:

On the other hand, it seems quite apparent that if the settled policy of the board of education, that it was legally bound to execute and the performance of which it had definitely entered upon, by the acts of the board itself had eliminated the possible use of the New Cumberland School as a building, they should not be indemnified against its loss to the extent of being paid by insurer its actual going value. *Ibid*.

It is on this basis, and certainly not on the basis of *Laurent v. Chatham*, that the West Virginia court affirmed judgment for \$8,000, not for the \$20,000 claimed as the building's value "as a building" by the insured.

The first of the quoted statements played absolutely no role in the court's decision of the *Hartford* case, or in its evaluation of the evidence therein. Had the court followed its own dictum, the

evidence concerning the school building's impending demolition would all have been "collateral" and "speculative" and the court would have had no basis for upholding a judgment awarding only 40 per cent of the building's value as claimed by the board of education. Instead the court found that "the board had permanently stopped using the New Cumberland School building for its intended purpose, and had begun the physical work of its removal." On this basis it affirmed the judgment of the lower court treating the building "as a collection of material, the use of which as a building had terminated." Whether the court arrived at this result by holding the "general rule" inapplicable, or because it did not really approve of the rule in the first place, is of only semantic interest. It is indisputable that the court followed *McAnarney* and rejected, or at least disregarded, *Laurent*.

The true significance of the *Hartford* decision was readily apparent to the federal district court in the case of *Greyhound Bldg. Corp. v. Fidelity-Phoenix Fire Ins. Co.*, No. 49 C 1539, 7 CCH Fire & Cas. Cases 597, 599 (N.D. Ill. 1951) (not otherwise reported). Citing *Hartford* as authority, the court stated that:

If plaintiff was legally bound to proceed with the demolition of the buildings before the date of the fire, the use of this (sic) buildings as buildings had terminated and cost of reproduction thereof cannot be considered in the question of damages.

G. THE REMAINING CASES CITED BY THE TRIAL COURT WERE NOT APPLICABLE.

We have already discussed *Laurent v. Chatham Fire Ins. Co.*, the principal case that the trial court relied upon in holding defendant's evidence on value to be irrelevant. See Part II-E, *supra*. The court also abstracted and relied on a series of other cases for the proposition that "the fact that a building was subject to removal or was soon to have been demolished by the owner, does not affect the right of the insured to recover its value as a building if it is destroyed or damaged by fire before the time for removal." R. 155.

Preliminarily, it may be noted that the Sisters in this case had made a binding agreement for the demolition of the old convent, and the demolition was in progress at the time of the fire. These facts alone are sufficient to distinguish nearly all of the cases relied on by the trial court. For instance, in *National Fire Ins. Co. v. School Dist. No. 68*, 115 F.2d 232 (10th Cir. 1940), the court said it was not impressed with defendant's contention that the destroyed school building had only salvage value "merely because it was *proposed* to construct a new school building largely through funds provided through the Works Progress Administration" (Emphasis added.) The court had little reason to be impressed, since there was not even a contract for the building's demolition, let alone an ongoing process of demolition at the time of the fire. Similarly, in *Irwin v. Westchester Fire Ins. Co.*, 109 N.Y.S. 612 (Spec. Term Orange Cty. 1908), the insured's building had been condemned as a nuisance several years earlier, but the insured had made no contract or other definite commitment for its demolition.

Neither *Washington Mills Emery Mfg. Co. v. Weymouth & Braintree Mut. Fire Ins. Co.*, 135 Mass. 503 (1883), nor *Washington Mills Emery Mfg. Co. v. Commercial Fire Ins. Co.*, 13 F. 646 (Cir. Ct. Mass. 1882), concerned the demolition of a building or a contract for demolition. Both cases arose out of a fire to a group of buildings located on property that the insured had deeded to the City of Boston with a provision that the buildings would be forfeited unless removed by a certain date, which had not arrived at the time of the fire. Following *Laurent v. Chatham*, the courts held in both cases that the insured's right of recovery for the buildings was not affected by the prospect of their forfeiture or removal. 135 Mass. at 505-07; 13 F. at 650. Ancestry as well as irrelevance deprived these cases of authority, for as we have shown above the *Laurent* principle has not been accepted by the California courts and cannot be squared with the view of insurance contracts that obtains in this State.

Eagle Square Mfg. Co. v. Vermont Mut. Fire Ins. Co., 212 A.2d 636, *reargument denied*, 213 A.2d 201 (Vt. 1965), also cited by the District Court, clearly supports defendant's position that evidence concerning the demolition of the old convent was relevant to its "actual cash value":

The search for the true value of insured property destroyed by fire is not confined to any single formula. Both the insured and his insurer are at liberty to resort to any evidence which logically aids in the formation of a correct estimate of the value of the property as it was before the damage occurred." 212 A.2d at 638.

The court had no opportunity to apply the broad evidence test in the *Eagle Square* case. It upheld the insured's verdict for the policy amount because the defendant "offered no independent evidence of value," 212 A.2d at 638, and "persistently maintained that 'the plaintiff had no interest whatsoever in the insured structure at the time of the loss.'" 213 A.2d at 202.

While contending earnestly that the Sisters had no insurable interest in the old convent at the time of the fire, defendant has not rested its case on such a contention. Defendant has consistently contended in addition for the application of a broad evidence test of value and has introduced extensive independent evidence on the question of value, all of which the court has treated as irrelevant. The situation after trial here bears no similarity to that confronting the court in the *Eagle Square* case.

Hughes v. Potomac Ins. Co., 199 C.A.2d 239, has already been discussed *supra* at pages 26-27. It deals exclusively with events occurring after, and not before a fire.

Wolf v. Home Ins. Co., 100 N.J. Super. 27, 241 A.2d 28 (1968), is in the same category. As the court in that case emphasized throughout its opinion, the case concerned the effect of "subsequent collateral events" that materialized five months after the fire. 241 A.2d at 28, 31, 38-40. Here the defendant did not rely on any events occurring after the fire, but on the fact that *before the fire* the insured had surrendered its building and received the agreed equivalent under its contract, so that it was precluded from

suffering any loss in the first place. Contrary to the trial court's statements in connection with these two cases, the company's indemnity risk does not oblige it to pay for a loss that is no loss, *Davis v. Phoenix Ins. Co.*, *supra*; *Smith v. Jim Dandy Markets, Inc.*, 172 F.2d 616, 618 (9th Cir. 1949), or, by disregarding the Sisters' binding and enforceable contract for the old convent's demolition, to put them in a better position than they were in before the fire occurred. See *Breshears v. Indiana Lumbermens Mut. Ins. Co.*, quoted *supra* at p. 35.

H. SUMMARY OF DEFENDANT'S POSITION THAT THE OLD CONVENT HAD NO SUBSTANTIAL ACTUAL CASH VALUE TO PLAINTIFF AT THE TIME OF THE FIRE.

The proper method for determining "actual cash value" under California law was the broad evidence test requiring the trier of fact to consider all evidence logically tending to formation of a correct estimate of such value. The trial court therefore committed reversible error in determining the actual cash value of the old convent by considering solely its replacement cost, less depreciation.

Viewed under the broad evidence test and in light of the application of this test in the closely analogous case of *Board of Education v. Hartford Fire Ins. Co.*, the evidence in this case proved conclusively that the old convent had no substantial actual cash value to the plaintiff at the time of its destruction. The trial court's erroneous determination that it did have such a value at that time was arrived at by disregarding the evidence and substituting a speculative basis of value, and by reliance on authorities that are not compatible with the law governing insurance contracts in California.

III. Plaintiff Increased the Hazard of Fire, So That the Policy Was Suspended at the Time of the Fire.

Defendant asserted as a special defense that, prior to the fire, the insured increased the hazard of fire to the building in violation of the policy, thereby suspending its coverage.

The policy provides (at l. 28-31) that:

Unless otherwise provided in writing added hereto this company shall not be liable for loss occurring (a) while the hazard is increased by any means within the control or knowledge of the insured; . . ."

The evidence showed that, at the time of the fire, the building had been vacated by the Sisters, that significant portions of electrical and plumbing fixtures and stained glass had been removed, that an auction of furniture and other materials had been held in the building, that the demolition of the building had begun and that the demolition subcontractor's employee, Neal, had taken down part of a fence around the convent, entered the building, ripped a large pipe away from the outside of the building, and left it lying on the ground outside the convent.

The cases uniformly hold that vacating a building and allowing it to take on the appearance of neglect, abandonment and devastation, as was clearly done in this case, is to increase the hazard of fire in a manner suspending insurance coverage on the building.

In *Westchester Fire Ins. Co. v. Fitzpatrick*, 2 F.2d 651, 653-54 (3rd Cir. 1924) the evidence showed that the City Building Inspector had inspected the building, condemned it as unsafe, and ordered its demolition by the insured, who in turn had ordered the tenants to vacate. Whether the tenants actually vacated before the fire is unclear. On these facts, the Third Court held that the trial court erred in refusing to instruct the jury that there was an increase of hazard if "prior to the fire the building inspector condemned the building and the plaintiff notified the tenants of such condemnation and ordered them to vacate the premises."

Similarly, in *Montello v. Manhattan Fire & Marine Ins. Co.*, 294 N.Y.S. 1015 (App.Div. 1937), the court ruled that the trial court improperly struck out the insurer's defense of an increase of hazard, citing the *Fitzpatrick* decision and holding that, if proved, allegations that the building's occupants had moved out, left it unguarded and permitted large portions of it to be stripped and removed, would show an increase in hazard, suspending the coverage.

In the leading case of *Goldman v. Piedmont Fire Ins. Co.*, 198 F.2d 712, 714 (3rd Cir. 1952), the plaintiff was storing his insured goods in a building that partially collapsed in a heavy snowstorm, but took no action to have the building repaired or to remove his goods to a safer place. A fire occurred in the building. Under appropriate instructions as to the defense of an increase in hazard the jury found for the defendant insurer. The Third Circuit affirmed the trial court's refusal to strike the defense of increased hazard, and the jury verdict for defendant. In so holding the court stated that:

Certainly the open and collapsed condition of the building invited the entrance of children and vagrants with a consequent increase in the risk of fires being started therein.

The decision in *Asbell v. Pearl Assur. Co.*, 59 N.J. Super. 324, 157 A.2d 728 (1960) is very relevant to the present case. After a fire occurred in the insured building, the insured vacated the building, leaving debris from the fire in and around the building. The insured testified he had arranged for a cleanup, but none had been carried out. A second fire followed and the insurer based its defense on increased hazard. Judgment for the company was upheld over the insured's contention that the defense was invalid because the company, by special endorsement, had waived a policy provision that coverage would be suspended if the building were vacant more than sixty (60) days. The court held that there was an increase of hazard separate and apart from the vacancy itself. Therefore the company's waiver of its right to suspend coverage based on the fact of vacancy alone in no way impaired its right to rely on the increase in hazard of which the vacancy was an important constituent.

Elements from each of the foregoing cases, together with other circumstances, coalesced to produce the increase in hazard that the evidence clearly established in this case. As in the *Westchester* case, *supra*, 2 F.2d at 651, the building inspector had found the convent to be a "fire hazard," had determined that it was not fit for human occupancy, and had served its occupants with notices

of Building Code violations. Abatement of the violations, otherwise called for under the Building Code, did not follow only because of the Sisters' assurances to the inspector that the Bishop was to build them a new convent and that the old building was shortly to be torn down.

Parts of the old convent had also been stripped and removed, as in the *Montello* case, *supra*, 294 N.Y.S. at 1015. Electrical fixtures and panels, plumbing fixtures, stained glass windows and a large sewer pipe had been removed. By the court's own finding, these fixtures amounted to almost 25 per cent of the building's overall value as determined by plaintiff's estimates.

The building had been vacated by its occupants, as in the *Asbell* case, *supra*. Moreover, the inside of the building may possibly have contained debris resulting from the removal of fixtures, akin to the debris remaining from the prior fire in the *Asbell* case.

Finally, although there was not a partial collapse of the building as in the *Goldman* case, it was demonstrably in a condition "invit[ing] the entrance of children and vagrants with a consequent increase in the risk of fires being started therein." This risk, only potential in the *Goldman* case, became actuality here. Whether or not the building itself was "open" to the entrance of such persons is not shown by the evidence, which did show, however, that the subcontractor's employee had broken down part of the fence around the convent.

The above analysis shows that an increase in hazard was found in each of the above cases on the basis of evidence that was only a fraction of that placed before the trial court in this case. *A fortiori* there was such an increase here, but the trial court rejected the defense.

Briefly, the court found that the building had not been vacant or unoccupied for sixty (60) consecutive days, that the building's exterior was in its usual condition and not such as to invite arsonists, that the building interior was not in a condition that would increase the hazard of fire, and that the Sisters' occupancy of the

convent up to the time of the fire was with the approval of the City. On this basis the court concluded that there had not been an increase of hazard suspending the policy. R. 150-52.

The court's findings and conclusions contradicted or did not fully consider the evidence, and were clearly erroneous. See Fed. R. Civ. P. 52(a). Moreover, the court failed to apply the law set forth in the above authorities.

Defendant was not required to prove that the building was vacant for more than sixty (60) consecutive days. Defendant did not rely on the "vacancy clause" containing this requirement, which is set forth at lines 32 through 34 of the policy, but on the increase of hazard provision set forth at lines 28 through 31 thereof. The amendment to defendant's answer refers specifically to that provision, and to no other. R. 130. The court's finding that no vacancy existed for sixty (60) days was therefore not material to, nor in any measure dispositive of, defendant's claim of an increase in hazard. On the contrary, the vacating of the building by plaintiff prior to the fire, coupled with the other evidence, clearly showed that a knowing increase of hazard had occurred. *Asbell v. Pearl Assur. Co., supra*.

It was equally immaterial to the defense that the City permitted the Sisters to remain in occupancy following the notices of Building Code violations. In *Westchester Fire Ins. Co. v. Fitzpatrick, supra*, the evidence relied on by the court did not show whether the tenants had actually vacated the condemned building. The turning point of the case was that the building had been condemned. So, too, in this case, it was not decisive whether the Building Inspector and the Building Department took immediate steps to terminate the Sisters' occupancy of the convent, or whether they relied, as they did in fact, on the Sisters' pleas that the Bishop would shortly build them a new convent. The understandable disinclination of the Berkeley officials to oust the Sisters from their home of more than eighty years in no way altered the fact that upon inspecting the convent, the Building Inspector had adjudged it a "fire hazard" that did not meet the requirements of the Building Code for human occupancy. Nor did it detract

in any measure from the fact that, when presented with this official judgment, the Sisters took no steps whatever to restore the building to a suitable condition for human habitation. The testimony of Shobring, the Building Inspector, showed that the City's "approval" was nothing but a discretionary suspension of enforcement, for he stated unequivocally that once the Sisters left the convent, they could not return without bringing the building into conformity. The Sisters' eventual vacation of the convent was therefore the practical equivalent of an official ouster.

Nor did the evidence permit a finding that the building's exterior was in its "usual condition" and not such as to invite arsonists. The building's destruction in a fire officially attributed to uninvited persons bears strong witness to the contrary. In addition, the building's exterior was shown to be materially altered by events occurring prior to the fire.

The building's "usual condition" did not permit the free access that was made available with the breaking of the fence that surrounded it. Since the time that the Sisters had ceased to use it for school classes several years earlier, the convent had been closed to the outside world, its fence both symbolizing and safeguarding the privacy of its occupants' religious pursuits. The lifting of that barrier conveyed as graphically as could any event that the Sisters had abandoned their sanctuary. If further confirmation of the Sisters' departure were needed, the gaping frames that had once enclosed the convent's stained glass windows and the sewer pipe lying upon the ground bore eloquent witness to the vacancy and disarray inside the building—conditions which could be confirmed by any stranger passing through the broken fence.

Paragraph 19 of the policy was aimed directly at an increase in hazard caused by the creation of conditions such as those described above. So far as material, that paragraph provides (R. 15):

Permission granted: (a) For such use of the premises as is usual and incidental to the business conducted therein and for existing and increased hazards and for change in use and occupancy except as to any specific hazard, use or occu-

pany prohibited by the express terms of this policy or by any endorsement thereto; . . .

(c) For the building(s) to be in course of construction, alteration or repair, . . . and to build additions thereto, . . .

The limited permission granted in this paragraph for the buildings to be in course of construction, alteration or repair clearly communicated to the Sisters that the policy did not permit a demolition of the building. Demolition involves a markedly greater risk of fire, particularly from an outside agency, than does construction, alteration or repair. Furthermore, it is typically accompanied by a lessening or, as in this case, a disappearance of the owner's interest in the building's protection and preservation, as opposed to the heightened interest that attends a building's alteration or repair.

Paragraph 19 did not permit the Sisters to increase the hazard to the building without limitation. The permission granted for increased hazard was clearly restricted, in context, to "such use of the premises as is usual and incidental to the business therein," and therefore excluded the demolition of the building. The conditions created by the demolition and the Sisters' preparations for it contributed materially to the old convent's destruction by fire. The trial court therefore erred in permitting the Sisters to recover despite the policy's clear prohibition of such a demolition.

IV. Interest Did Not Begin to Run Until the Date of Judgment.

If there is a substantial dispute, as there was in this case, concerning the actual cash value of property insured against fire, the insured's claim is uncertain in amount and is incapable of being made certain by calculation. Cf. Calif. Civil Code § 3287. Thus, where the insured and the company disputed the value of property that was in the process of being condemned at the time of the fire, see *Browner v. Pearl Assur. Co.*, 267 F.2d 45 (9th Cir. 1958), this Court held, for the above reasons, that interest did not begin to run until the date of judgment. *Browner v. Pearl Assur. Co.*, 285 F.2d 120 (9th Cir. 1961) (*per curiam*).

Another excellent illustration of this principle is *Benton v. Cravens, Dargan & Co.*, 188 C.A.2d 637, 645 (1961), an opinion by then Justice Duniway of the First District Court of Appeal. In reversing a judgment for prior interest, the Court stated:

As the record shows, and as the court stated, the evidence as to the value of the tractor, 'ranged from \$2,500 to \$7,000.' The underwriters did not agree to pay a fixed sum of money, as in a contract of life insurance. They agreed to pay the actual cash value of the stolen tractor. This was, under the facts of the case, unliquidated, and pre-judgment interest should not have been awarded.

In *Lineman v. Schmid*, 32 Cal.2d 204, 209-10 (1948), a leading authority cited in the *Benton* opinion, the California Supreme Court concluded after reviewing the authorities in California and under the general law that:

The rule appears to be uniform, whether the case involved contract price or reasonable value, that interest is not allowable when damages cannot be computed except on conflicting evidence, such as in the present case, because of the absence of established or reasonably ascertainable market prices or values. In such cases, since the amount of the damages cannot be resolved except by accord, verdict or judgment, interest prior to judgment is not allowable.

Under *Lineman v. Schmid*, the present law in California is that "where the amount of damages cannot be ascertained except by the resolution of conflicting evidence, interest cannot be awarded under Section 3287." *City of Salinas v. Souza & McCue Construction Co.*, 66 Cal.2d 217, 230 (1967).

Plaintiff in this case actively contended that the insured property had no market value in the usual sense of the words, and that its actual cash value was not ascertainable by reference thereto. It certainly cannot be heard to assert the contrary for the purpose of obtaining pre-judgment interest. Plaintiff is equally precluded from arguing that its damages were ascertainable on the face of the contract, or by calculation based thereon. The policy was concededly an open, not a valued one, and called

for payment of the property's "actual cash value," not the policy's face amount. See *Benton v. Cravens, Dargan & Co.*, *supra*. Not only were the estimates of the building's value and of plaintiff's damages conflicting, but the method for determining such value, and the relevance of certain evidence thereto, were not the subject of any directly controlling decision under California law. These points were vigorously disputed throughout the trial, and are yet to be determined on this appeal. Furthermore, even though the trial court accepted plaintiff's basic estimates of value, its method for determining value, and its contention that certain evidence was irrelevant, there was still a substantial variation of \$36,000 between plaintiff's claim and the award to which the court held it entitled under the proof. This variation reinforced the more fundamental reasons outlined above that required the denial of interest before judgment. The award of interest prior to judgment, in opposition to these authorities, was an error of law that requires modification, even if the judgment be otherwise affirmed.

CONCLUSION

For the reasons set forth in the Argument above and on the basis of the authorities therein, defendant respectfully submits that:

1. The judgment of the District Court should be reversed and the cause remanded to said Court with directions to enter judgment for defendant, upon the grounds that:

- a. Plaintiff had no insurable interest in the St. Joseph's Convent at the time of the fire; and/or

- b. Plaintiff had increased the hazard of fire to the St. Joseph's Convent by means within its knowledge and control, so that the coverage of the policy was suspended at the time of the fire.

2. Alternatively, the judgment of the District Court should be reversed and the cause remanded to said Court with directions to:

a. Determine the actual cash value of the St. Joseph's Convent just prior to the fire by considering all evidence produced by both parties that logically tends to the formation of a correct estimate of such value at such time, including specifically the evidence produced by defendant concerning: (1) plaintiff's Agreement dated April 20, 1964 for the demolition of said convent and the actions of plaintiff, the Roman Catholic Bishop of Oakland, and of third parties acting for plaintiff and/or the Bishop, in the performance of such Agreement; and (2) the evidence produced by defendant concerning the conditions of the St. Joseph's Convent in violation of the Berkeley Building Code prior to the fire, the necessity and expense of remedying such violations prior to any reoccupancy of the convent, and the conditions produced by the removal of substantial building fixtures prior to the fire; or

b. Determine the actual cash value of St. Joseph's Convent just prior to the fire at a new trial at which both parties shall be free to present any evidence logically tending to the formation of a correct estimate of such value at such time and the court shall consider all of such evidence in its determination.

3. The judgment, even if affirmed in whole or in part, should be modified by deleting the allowance of interest thereon prior to the date of judgment.

San Francisco, California

December 1, 1968

Respectfully Submitted,

AUGUSTUS CASTRO,
JOHN D. HOFFMAN,

*Attorneys for Appellant
Royal Insurance Company, Ltd.*

No. 23,013

FEB 24 1969

IN THE
United States Court of Appeals
For the Ninth Circuit

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|-------------------------------------|---|-------------------|
| EDWARD R. BACON COMPANY, | } | <i>Appellant,</i> |
| vs. | | |
| WILLIAM B. GROVER, Trustee in Bank- | | |
| ruptcy, | | <i>Appellee.</i> |

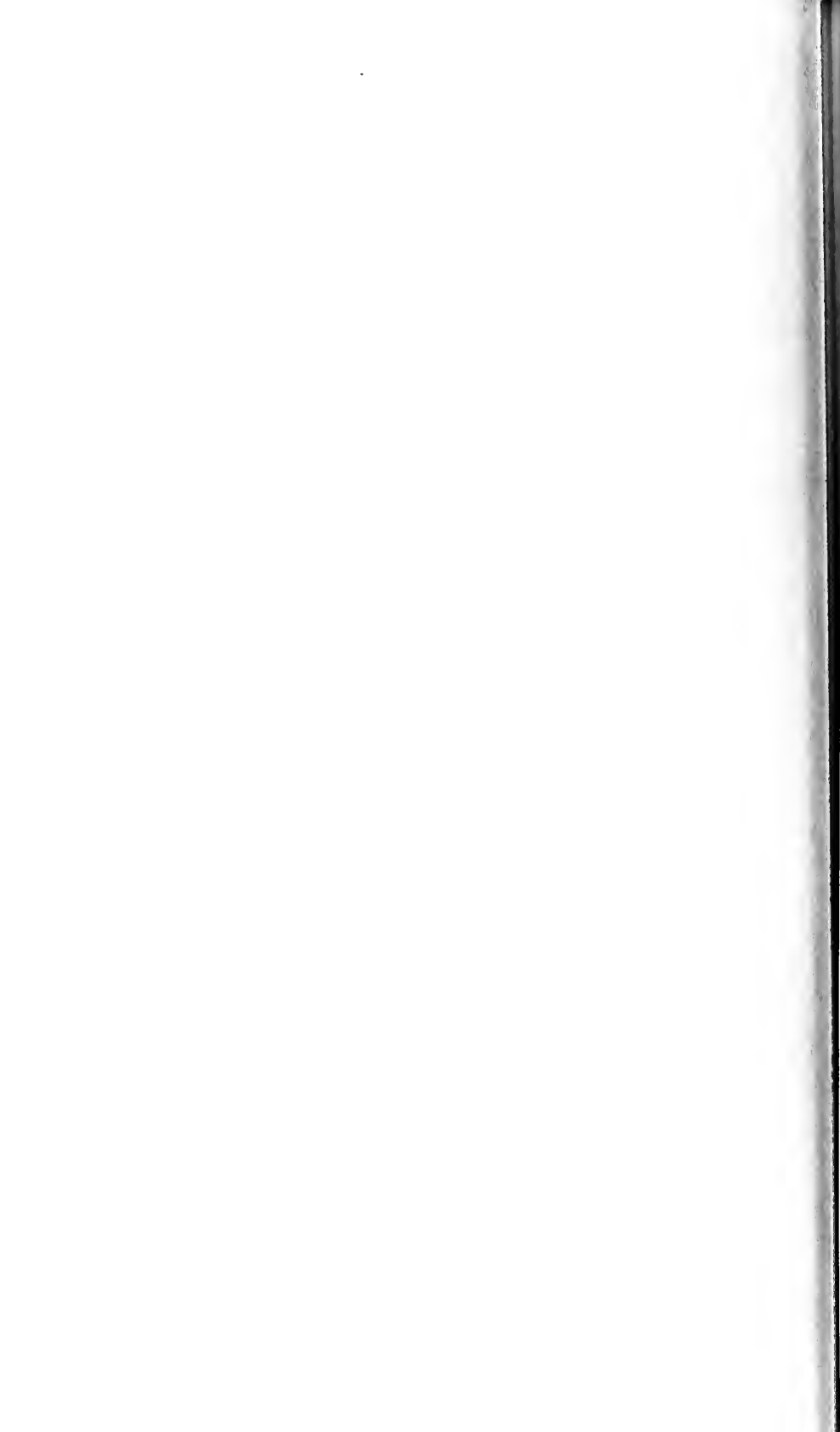
APPELLANT'S REPLY BRIEF

ANIXTER & ARONSON,
ARTHUR P. SHAPRO,
P. O. Box 231,
1450 Chapin Avenue,
Burlingame, California 94010,
Attorneys for Appellant.

FILED

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WM. B. LUCK



No. 23,013

IN THE

United States Court of Appeals

For the Ninth Circuit

EDWARD R. BACON COMPANY,

Appellant,

vs.

WILLIAM B. GROVER, Trustee in Bankruptcy,

Appellee.

APPELLANT'S REPLY BRIEF

ARGUMENT

Appellee neglects to state that the testimony of Mr. Lipary was stricken and is of no value on appeal.

In the first paragraph on page 4 of his Brief, Appellee attempts to state the legal question now before the Court. The statement of the issue there reads:

“The question thus is limited to this: Does the voluntary payover of the funds by the levying officer to the attaching creditor, in the absence of judgment or judicial sale, prevent the Trustee from reaching the property levied upon?”

We submit that the statement is incomplete and should read:

The question thus is limited to this: Does the voluntary payover of the funds by the levying officer to the attaching creditor, in the absence of judgment or judicial sale, prevent the Trustee from reaching the property levied upon by virtue of the provisions of Section 67 of the Bankruptcy Act. (11 U.S.C. 107) ?

Appellee argues on pages 5 and 6 of his Brief that misuse of Section 67 (as he alleges it was misused here) could be used as a method of obtaining preferential treatment. Appellee states on page 6:

“A typical example of how judicial lien procedure can be used to avoid preference is illustrated in the following set of circumstances: A creditor attaches and thus obtains an attachment lien, within four months prior to bankruptcy, followed by a voluntary acquiescence of the debtor in the payover by the levying officer of the fund attached, to the attaching creditor. By the use of this device, a creditor can contend that the lien of the attachment was destroyed by the voluntary payover, thus avoiding the impact of Section 60 (the preference section) since there was no receipt of funds directly from the bankrupt to the creditor. This is the thing that occurred in this case. After attachment but before bankruptcy, the creditor obtained a voluntary release from the bankrupt permitting the levying officer to pay over the funds to the attaching creditor. *By dint of this stratagem the creditor now contends that he is free from both Section 60 and Section 67.* We submit that it is just this type of situation that the two additions to Section 67(a) above set out were designed to cure.” (Emphasis added.)

Firstly, Appellee in the emphasized portions of the above quotation completely misstates Appellant's position. As is clearly demonstrated in Appellant's Opening Brief, Appellant specifically argues that Section 60 of the Bankruptcy Act *is* applicable and that if Appellee had pleaded and proved a voidable preference against Appellant he could have recovered under that section. Our position with reference to Section 60 is not that it is inapplicable, but that Appellee has neither pleaded nor proved his case thereunder.

Secondly, such an argument as set forth above is, in the mind of the writer, illogical and contrary to the authorities cited in Appellant's Opening Brief. Such a device as described in Appellee's argument would not avoid the consequences of Section 60 of the Bankruptcy Act. If the elements of a voidable preference could be shown to have existed, the transfer would be set aside. Even though the payment might be made by the sheriff under the authority of a writ, the transfer is being made by the debtor, the sheriff acting only as a conduit for payment. Appellee's argument with reference to attempts of debtor to make preferential payments to some creditors (page 6) actually makes our point for us. As we stated in our Opening Brief, if Appellee had proved that Appellant had received the money under circumstances amounting to a voidable preference the transfer could be set aside. But no such remedy was sought or proved by Appellee as he so states on page 1 of his brief, to wit:

"The Findings of Fact do not support any recovery under Section 60, the preference section,

and none is attempted, and as to the issue raised therein in Appellant's Brief, the same does not exist."

Appellee has cited only one case in his brief, the case of *Howarth v. Universal C.I.T. Credit Corporation*, 203 F. Supp. 279. This case makes precisely the point we raised in our Opening Brief and supports the contentions of Appellant, not Appellee. Appellee mischaracterizes the nature of the writ referred to in the *Howarth* case. In *Howarth* the writ referred to was *not* a writ of attachment as such writ is known in California, but rather was a writ of "attachment execution" pursuant to a Judgment. Obviously, a writ of "attachment execution" in Pennsylvania is equivalent to a writ of execution in California. In any case, the Judgment Creditor obtained payment under the writ within four months of bankruptcy, at a time that the Debtor was insolvent. As Appellant points out in his brief, the Court did hold that such a lien (if it still existed) would be null and void. But the Court recognized that once payment is made, the lien is merged in the payment and cannot be set aside under Section 67. The Court held that Section 60 is applicable and if the Trustee is to recover the payment he must do so by proving a voidable preference under that section of the Bankruptcy Act. The Court explicitly based its decision on Section 60 and in its opinion on the top of page 283 stated,

"We hold that the bank cash garnisheed by U.C.I.T. is a *voidable preference*, and the plaintiff-trustee is entitled to recover \$6734.21." (Emphasis added.)

We could not agree more with the *Howarth* case. If the Trustee in our case could prove a voidable preference he would be entitled to recover, but absent such proof, he cannot. Creditors are offered ample protection against preferential payments by Section 60 of the Bankruptcy Act. Why should the Appellant, after all, be in a worse position than another creditor who receives a preferential transfer directly from the Debtor simply because Appellant levied a writ of attachment and was paid from the attached funds *at the direction of the Debtor*? Clearly, the same rule should apply to both such creditors and absent proof of a voidable preference Appellee should not be allowed to recover.

Dated, Burlingame, California,
October 30, 1968.

Respectfully submitted,
ANIXTER & ARONSON,
ARTHUR P. SHAPRO,
By HENRY COHEN,
Attorneys for Appellant.



No. 23,013

United States Court of Appeals
For the Ninth Circuit

EDWARD R. BACON COMPANY,

Appellant,

VS.

WILLIAM B. GROVER, Trustee in Bank-
ruptcy,

Appellee.

APPELLANT'S OPENING BRIEF

ANIXTER & ARONSON,

ARTHUR P. SHAPRO,

P.O. Box 231,

1450 Chapin Avenue,

Burlingame, California 94010,

Attorneys for Appellant.

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No. 23,013

United States Court of Appeals For the Ninth Circuit

| | |
|---|-------------------|
| EDWARD R. BACON COMPANY, | } |
| vs. | |
| WILLIAM B. GROVER, Trustee in Bankruptcy, | |
| | <i>Appellant,</i> |
| | <i>Appellee.</i> |

APPELLANT'S OPENING BRIEF

STATEMENT OF THE ISSUES PRESENTED FOR REVIEW

1. Whether or not Section 67 of the Bankruptcy Act (11 U.S.C. 107) is applicable to the facts of this case and if so whether or not the Trustee in Bankruptcy of Outlet Construction Company, Appellee herein, proved his case for recovery under that section.

2. Whether or not said Trustee in Bankruptcy pleaded or proved a voidable preference against Appellant Edward R. Bacon Company pursuant to the provisions of Section 60 of the Bankruptcy Act (11 U.S.C. 96).

STATEMENT OF THE CASE

On October 13, 1966, Appellant Edward R. Bacon Company, hereinafter referred to as "Bacon", commenced an action against the bankrupt, Outlet Construction Company, hereinafter referred to as "Outlet", in the Municipal Court in the City and County of San Francisco, State of California, to wit, Action No. 571443. In this action and on October 20, 1966, Bacon caused a Writ of Attachment to be levied on the bank account of Outlet at the Bank of Willits, Willits, Mendocino County, California. On December 2, 1966 the Sheriff of the County of Mendocino received written instructions from Outlet to pay over to Bacon out of the attached funds the sum of \$756.71 in full satisfaction of Bacon's claim. Sometime between December 8, 1966 and December 13, 1966 said Sheriff paid said sum of \$756.71 to Bacon and on December 13, 1966 returned the Writ of Attachment to the Clerk of the San Francisco Municipal Court which return on its face showed the Writ to be wholly satisfied. The return was received into evidence as Trustee's Exhibit 1. Outlet filed a voluntary petition in bankruptcy on February 2, 1967.

William B. Grover, Appellee, as Trustee of the estate of Outlet Construction Company, bankrupt, hereinafter referred to as "Trustee", filed a Petition for Turnover Order upon which a hearing was had and the Referee entered an Order adverse to Bacon and by which Order Bacon was ordered to repay said sum of \$756.71 to the Trustee. A Petition for Review was filed by Bacon and the Order of the

Referee was affirmed by the District Court without opinion.

ARGUMENT

I. THE TRUSTEE CANNOT RECOVER THE \$756.71 UNDER THE PROVISIONS OF SECTION 67 OF THE BANKRUPTCY ACT (11 U.S.C. 107).

A. Section 67 of the Bankruptcy Act (11 U.S.C. 107) is not Applicable to the Facts of This Case.

From a reading of the pleading filed by the Trustee (Transcript of Record, Vol. 1, pages 4-5) it appears that he sought to have the payment to Bacon set aside on the ground that Bacon obtained a lien on the bankrupt's property within four months of bankruptcy, at a time when the bankrupt was insolvent. Section 67 a (1) of the Bankruptcy Act (11 U.S.C. 107 a (1)) provides:

"Every lien against the property of a person obtained by attachment, judgment, levy, or other legal or equitable process or proceedings within four months before the filing of a petition initiating a proceeding under this Act by or against such person shall be deemed null and void (a) if at the time when such lien was obtained such person was insolvent or (b) if such lien was sought and permitted in fraud of the provisions of this Act: Provided, however, That if such person is not finally adjudged a bankrupt in any proceeding under this Act and if no arrangement or plan is proposed and confirmed, such lien shall be deemed reinstated with the same effect as if it had not been nullified and voided."

Section 67 of the Bankruptcy Act is inapplicable to the facts of this case because no lien existed on any property of Outlet in favor of Bacon on the date of bankruptcy. Bacon's claim had been fully paid by Outlet. The lien was released by the Sheriff who levied it and the Writ of Attachment on which the lien was based was returned fully satisfied. All of this occurred *before* onset of bankruptcy. Section 67 of the Bankruptcy Act applies to liens existing on the bankrupt's property on the date of bankruptcy and where the property against which a lien is claimed is on the date of bankruptcy in the possession of the bankrupt, actual or constructive. This principle was recognized by this Court in *Abramson v. Gardner*, 1958, 253 F.2d 518, although in *Abramson v. Gardner* the Court could not apply the principle because on the date of bankruptcy the property was still in the hands of the bankrupt. The Court recognized, however, that when the lien is converted into title prior to bankruptcy Section 67 of the Bankruptcy Act is not applicable. The Court in *Abramson v. Gardner*, *supra*, based the right of the trustee there to proceed under Section 67 on the sole issue of change of possession and on page 521 of the opinion states,

"The effect of lack of change of possession of the property executed against is controlling in this case. . . . It permits the trustee at all events to proceed under Section 67 rather than Section 60 of the Bankruptcy Act. . . ."

Conversely, in our case, the lien was converted into title. The Sheriff was instructed to pay the money

to Bacon in satisfaction of Bacon's claim. Upon such payment being made the money became the property of Bacon and title therein vested in Bacon. Furthermore, the money was not in the possession of the bankrupt on the date of bankruptcy but rather was in the hands of Bacon. It is stated in 4 *Collier on Bankruptcy*, 14th Edition, Section 67.15 (4) at page 174,

“Where the lien of a judicial proceeding has been enforced by the sale of the debtor's property subject thereto and the proceeds paid over to the lien creditor prior to the debtor's bankruptcy, the lien becomes merged in the payment and accordingly cannot be effected by Section 67 a. notwithstanding the occurrence of bankruptcy within four months of the acquisition.”

It is true that in the instant case there was no execution sale but rather a voluntary payment of attached funds. But the principle is the same. The lien of the attachment became merged in the payment of the money to Bacon and the payment cannot be effected by Section 67. Title to the funds passed to Bacon upon payment being made. The principle is further set forth in the aforementioned *Collier* citation at page 175 as follows,

“So long as payment of the proceeds has *not been* made to the lien creditors his rights by virtue of the legal proceedings are, therefore, subject to interception by filing of the bankruptcy petition (Emphasis added).

On page 136 the text states,

“If the *garnishing* creditor has received payment in satisfaction of his lien prior to bank-

ruptcy, the trustee would have no remedy under Section 67. The payment may, however, constitute a preference and be recoverable under Section 60." (Emphasis added)

In our case, payment of the proceeds had been made to the lien creditor and therefore such rights are not subject to interception by the filing of the petition in bankruptcy under Section 67.

We shall discuss below the question of voidable preferences and what effect, if any, Section 60 of the Bankruptcy Act (11 U.S.C. 96) has on the facts of this case.

B. Even if Section 67 of the Bankruptcy Act were Applicable to the Facts of this Case, the Trustee has Failed to Prove his Case Thereunder.

We believe that we have demonstrated above that the trustee cannot predicate recovery under Section 67 of the Bankruptcy Act under the facts of this case. We shall now attempt to point out that even if Section 67 were applicable that the trustee has failed to prove his case.

II. THE EVIDENCE DOES NOT SUPPORT THE FINDING THAT AT THE TIME OF THE LEVY OF THE ATTACHMENT (OCTOBER 20, 1966) OUTLET WAS INSOLVENT.

Under Section 67 it is incumbent upon the trustee to prove that at the time of the levy of the Writ of Attachment that Outlet was insolvent and insolvency must exist at the time the lien attaches, *Liberty National Bank of Roanoke, Virginia v. Bear*, 265

U.S. 365, 44 S.Ct. 499, 68 L. Ed. 1057. The trustee did not sustain his burden of proof as to insolvency and the finding of insolvency is clearly erroneous. (Finding of Fact Number 3, Transcript of Record, Vol. 1, page 13).

As his first witness to establish insolvency the Trustee called Joseph Lipari, who was a general partner of Outlet. Mr. Lipari's testimony is found in the Reporter's Transcript at page 3, line 1 to page 14, line 4. Mr. Lipari could not testify from his own knowledge that Outlet was insolvent on October 20, 1966, the date of the levy of the attachment. Mr. Lipari could only testify what the books of Outlet showed. Counsel for Bacon moved that the testimony be stricken (R.T. p. 7, lines 9-10) and the Court granted the motion. Objections to questions by the Trustee directed toward eliciting from Mr. Lipari testimony as to value of assets and amount of liabilities were sustained (R.T., p. 8, lines 1-7; page 15, lines 5, 12-20; page 16, lines 1-10). There is no testimony of Mr. Lipari remaining in the record that can substantiate the finding that on October 20, 1966 Outlet was insolvent.

The Trustee next called Thomas H. Carter, Jr., a certified public accountant, who testified he maintained and supervised the records and accounts of Outlet during 1966. His testimony is found in Reporter's Transcript, page 17, line 6 to page 40, line 10. On direct examination, Mr. Carter did not testify from the prepared financial statements of Outlet but referred only to work papers which he had in his

possession. He made no mention of prepared financial statements. He did testify that the work papers were prepared from the books of Outlet (R.T., p. 17, line 24 to p. 20, line 18). Upon cross examination, however, there was elicited the following testimony which we deem important enough to reproduce, which testimony is found in Reporter's Transcript, p. 20, line 20 to p. 21, line 23:

Q. (By Mr. Cohen) May I see your records, please?

A. The work sheets?

Q. Yes. You also referred to a letter, I believe, while you were testifying, and may I see that also?

A. Yes.

Q. I see here, Mr. Carter, a letter dated October 20, 1966, addressed to Outlet Construction Company, Willits, California, and to that letter are attached Exhibit A and Exhibit B. Exhibit A is labeled Outlet Construction Company, a limited partnership, Statement of Financial Condition, September 30, 1966, and I ask you if you can identify that document for me and tell me what it is?

A. Well, it's a Balance Sheet.

Q. Did you prepare that Balance Sheet?

A. Yes, I did.

Q. Does it truly reflect the condition of the organization as of that date?

A. To the best of my knowledge it does.

Q. Now, according to this Balance Sheet, what were the assets of the organization on September 30, 1966?

A. Three hundred and eight thousand seven forty-one-0-nine.

Q. And what were the liabilities?

A. Two hundred and thirty-five thousand nine twenty-three twenty-six.

Q. According to this statement, the assets on September 30, 1966 exceeded the liabilities, isn't that correct?

A. That is correct.

Q. Well, why doesn't that agree with your working papers that you testified from?

A. It does agree with them.

The letter and balance sheet were accepted into evidence as Bacon's No. 1.

Further cross examination elicited from Mr. Carters' testimony that he also prepared a balance sheet as of November 30, 1966, which balance sheet showed that as of November 30, 1966 the assets of Outlet exceeded its liabilities. The portions of the testimony we deem relevant regarding this balance sheet is found in Reporter's Transcript p. 30, line 3 to p. 30, line 13, page 33, lines 2-22 and reads as follows:

Q. Mr. Carter, you have a financial statement here dated November 30, 1966, showing a Balance Sheet for Outlet Construction Company?

A. Yes.

Q. Is that a balance sheet showing the assets and liabilities of that company as of November 30, 1966?

A. Yes, on a going concern basis.

Q. The same as the other statement?

A. Yes.

Mr. Cohen: I believe that is sufficient, Your Honor.

The Court: We will let it go in, then.

Q. You prepared the statement knowing that it would be used to obtain a loan?

A. Mr. Lipari said he was trying to get a loan.

Q. Well, you knew the statement would be used, didn't you?

A. Would be offered in order to try to get a loan, yes.

Q. You knew it would be used for that purpose?

A. Yes.

Q. You certainly didn't intend to put anything in this statement that was untrue, did you?

A. No.

Q. As far as you are concerned, then, this statement is correct?

A. To the best of my ability when that statement was prepared, it was correct.

Q. Now, will you tell me what the assets were of the limited partnership, what the assets and liabilities were on November 30, 1966?

A. The assets were four hundred sixty seven thousand three hundred eighty-three dollars and eighty cents.

Q. What were the liabilities?

A. Three hundred twenty-one thousand three hundred twenty-seven dollars forty cents.

By a review of the testimony of the Trustee's witness and by a review of the financial records of the bankrupt itself it becomes clear that on October 20, 1966 Outlet was solvent. Insolvency is defined in Section 1 (19) of the Bankruptcy Act (11 U.S.C. 1 (19)),

"A person shall be deemed insolvent within the provisions of this Act whenever the aggregate

of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed, or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts;”

Mr. Lipari added nothing to the issue of insolvency and the balance sheets of September 20, 1966 (Bacon's No. 1) and November 30, 1966 (Bacon's No. 2) which Mr. Carter testified reflected the true financial condition of Outlet each show that on the respective dates the assets of Outlet exceeded its liabilities.

III. RECOVERY BY THE TRUSTEE CANNOT BE PREDICATED ON SECTION 60 OF THE BANKRUPTCY ACT (11 U.S.C. 96) AS A VOIDABLE PREFERENCE.

A. Relevant Distinctions Between Sections 67 and 60 of the Bankruptcy Act.

It is important to distinguish between the invalidation of a lien under Section 67 of the Bankruptcy Act and the avoidance by the Trustee of a preferential transfer under Section 60 of the Bankruptcy Act. Under Section 67 quoted above the trustee can have declared null and void a lien existing on the date of bankruptcy if the lien was obtained within four months next preceding bankruptcy at a time when the bankrupt was insolvent. On the other hand, Section 60 deals with *transfers* made by the bankrupt to a creditor within four months next preceding bankruptcy. Are we not here concerned with the

transfer of funds made from Outlet to Bacon rather than avoidance of a lien existing on the date of bankruptcy? As stated above the lien became merged in the payment and we are not now concerned with the lien but rather with the payment. Again, quoting from page 136 of 4 *Collier on Bankruptcy*, 14th Edition, *Supra*,

“If the garnishing creditor has received payment in satisfaction of his lien prior to bankruptcy the trustee would have no remedy under Section 67. The payment may, however, constitute a preference and be recoverable under Section 60.”

B. The Trustee has not Proved a Case for Recovery of a Voidable Preference Under Section 60 of the Bankruptcy Act.

Section 60 a. (1) of the Bankruptcy Act (11 U.S.C. 96 (a) (1)) defines a preference as follows,

“A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.”

The first sentence of Section 60 b. (11 U.S.C. 96 (b)) states the condition on which a preference can be avoided by the Trustee and reads as follows:

“Any such preference may be avoided by the trustee if the creditor receiving it or to be bene-

fited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent."

The Trustee in his original petition included an allegation that at the time of the levy of the attachment Edward R. Bacon Company had reasonable cause to believe that Outlet Construction Company was insolvent. Apparently the Trustee did at least consider an action to set aside the payment of the money to Petitioner on the grounds that such payment constituted a voidable preference. Such an allegation is not necessary for recovery under Section 67 of the Bankruptcy Act. It is well established and we shall hereafter show that a far different measure of proof is required in order for the Trustee to avoid a transfer as a preference as opposed to setting aside a lien under Section 67. We concede that the payment of funds to Edward R. Bacon Company by the bankrupt was made within four months of bankruptcy. But that is only one of the elements of a voidable preference. The Trustee must prove *each and all* of the essential elements and failure to do so precludes any recovery under Section 60, 3 *Collier on Bankruptcy*, 14th Edition, Section 60.62, pages 1123, et seq.; the treatise there states,

"The law places upon the trustee (or receiver) the unmistakable burden of proving by a fair preponderance of all the evidence every essential controversial element resulting in the composite voidable preference." (cases cited)

These elements are, to wit, (1) that there was a transfer of the debtor's property, (2) that the transfer was to or for the benefit of a creditor, (3) that the transfer was for or on account of an antecedent debt, (4) that the transfer was made or suffered while the debtor was insolvent, (5) that the transfer occurred within four months next preceding adjudication, (6) that the effect of the transfer was to enable the creditor to obtain a greater portion of his debt than other creditors of the same class, and (7) that at the time of the transfer the transferee had reasonable cause to believe that the debtor was insolvent.

Based on the pleadings alone the trustee cannot recover on the basis of a voidable preference. In order for the trustee to recover under Section 60 his petition must allege each of the elements constituting a recoverable preference, *Barry v. Cramer*, 1952, 192 F.2d 939; *First National Bank v. Fox*, 1940, 111 F.2d 810. The trustee has not even pleaded elements 2, 3 and 6 as set forth above. And even if a cause of action to set aside the transfer as a voidable preference were well pleaded, such a cause of action has not been proved.

The record discloses that the Trustee did not even offer any proof on the following essential elements,

1. that the transfer was to a creditor;
2. that the transfer was on account of an antecedent debt;
3. that the effect of the transfer was to enable Edward R. Bacon Company to obtain a

greater portion of his debt than other creditors of the same class, and

4. that at the time of the transfer the transferee had reasonable cause to believe that the debtor was insolvent.

Based alone on this total failure to offer proof, the decision below cannot be upheld on the basis of a voidable preference having been made under Section 60 of the Bankruptcy Act. Furthermore, the record is not sufficient to establish insolvency on the part of Outlet as of the date of the payment to Bacon.

CONCLUSION

No lien in favor of Bacon against property of Outlet existed on the date of Bankruptcy. The lien was merged in the payment of money to Bacon. Inasmuch as there was no lien on the date of bankruptcy, Section 67 of the Bankruptcy Act has no application to the facts of this case. Even if Section 67 were applicable to the facts of this case the Trustee did not prove that Outlet was insolvent on the date of the levy of the Writ of Attachment, to wit, on October 20, 1966. Furthermore, the trustee cannot predicate recovery herein under Section 60 of the Bankruptcy Act based on the transfer of money from Outlet to Bacon for the reason that he has neither pleaded nor proved those elements essential to establishing a case for a voidable preference.

There is simply no basis on which the judgment of the Court below can be sustained and we respectfully submit that this Honorable Court should reverse the decision below.

Dated, Burlingame, California,
September 19, 1968.

Respectfully submitted,
ANIXTER & ARONSON,
ARTHUR P. SHAPRO,
By HENRY COHEN,
Attorneys for Appellant.

No. 23,013

United States Court of Appeals
For the Ninth Circuit

EDWARD R. BACON COMPANY,

Appellant,

vs.

WILLIAM B. GROVER, Trustee in Bank
ruptcy,

Appellee.

APPELLEE'S BRIEF

FREDERICK L. HUGER,

944 10th Street

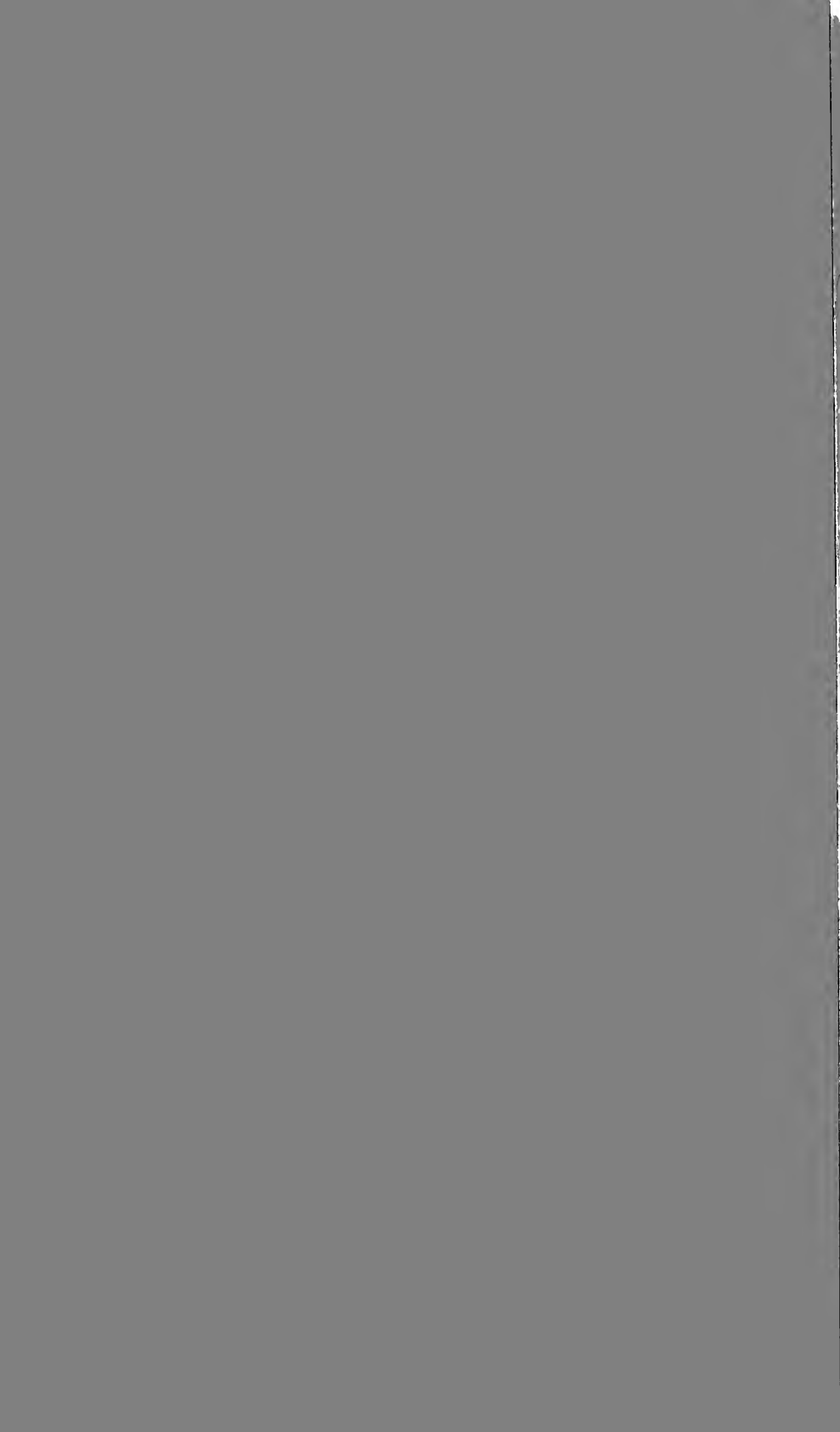
San Francisco, California 94101

Attorney for Appellee.

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WM. B. GILBERT



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No. 23,013

United States Court of Appeals

For the Ninth Circuit

EDWARD R. BACON COMPANY,
Appellant,

vs.

WILLIAM B. GROVER, Trustee in Bankruptcy,
Appellee.

APPELLEE'S BRIEF

STATEMENT OF THE ISSUES PRESENTED FOR REVIEW

The only issue in this matter appears to be whether or not the provisions of Section 67 of the Bankruptcy Act can be used to nullify a transfer made in the enforcement of an attachment lien, obtained less than four months prior to the filing of the bankruptcy petition, at a time when the debtor was insolvent.

The Findings of Fact do not support any recovery under Section 60, the preference section, and none is attempted, and as to the issue raised therein in Appellant's Brief, the same does not exist.

ARGUMENT

On the issue as to whether or not Outlet Construction Co. was insolvent at the time of the levy of at-

tachment, the evidence is clear that it was. The testimony of Lipary at page 3 of the Transcript, is that there was no substantial change between the assets and the liabilities from four months prior to bankruptcy until the date of filing. Those schedules in bankruptcy listing assets and liabilities are in the files of the Court and can be the object of judicial notice and they reveal insufficiency of the assets to pay the liabilities. Upon the basis of the schedules, Outlet was adjudicated as insolvent, and a bankrupt. In addition, Lipary testified (Tr. 3) that the assets were less than the liabilities.

The accountant, Carter, testified that the liabilities exceeded the assets at September 30th preceding the levy of attachment on October 20, 1966 (Tr. 19).

Bacon attempted to establish by financial statement showing an accounting net worth, that Outlet was solvent as at September 30th. The accountant testified however that there was in excess of \$75,000 of non-salable assets, having no fair value, included therein for accounting purposes, such as prepaid interest, prepaid rent, leasehold improvements and the like that could not be sold at any fair value, and that the result of recognizing this lack of value indicated an excess of liabilities over assets (Tr. 25).

A pro-forma balance sheet, prepared for the purposes of demonstrating the position of the Company after a loan application was introduced by Bacon to attempt to show a net worth of \$146,000 (Tr. 33). Complete examination of that statement reveals however that beginning at September 30th, when the

assets were not as great as the liabilities, there had intervened in the period to November 30th, an additional loss of \$36,000 with the investment of no additional capital in terms of assets paid into Outlet (Tr. 35.) There had been recorded an inflationary prepaid interest item, reflecting the obligation of the partnership to pay one of its partners for a discount he had sustained in making assets available to the partnership, which asset, of course, was not salable. The total of non-salable "accounting" assets recorded on the November 30th statement, was prepaid interest \$73,000.; prepaid rent \$3,500.; prepaid insurance \$5,800; prepaid rent \$57,000, totalling \$140,000 of non-salable assets shown for accounting purposes only (Tr. 38, 39). When these non-salable accruals are deducted from the net worth of \$146,000 shown on the November 30th statement, it leaves an accounting net worth of \$6,000. Included in the figures to produce this result however, was \$75,500 write-up in the fixed assets by "appraisal" and \$71,400 write-up in the inventory, by "appraisal". These appraisal write-ups were not salable, nor did they constitute fair value of the assets for the purpose of determining solvency, since Mr. Lipary testified without equivocation (Tr. 13) that cost, rather than the appraisal, would have been the fair value to use (Tr. 13).

After the appraisal write-ups are removed from the November 30th statement the actual status of the Company in fair value of its assets, compared to its liabilities there is a deficit of \$140,400. This evidence fully supports a finding of insolvency from and after September 30th through the date of the levy on Octo-

ber 20th, and continuing up until the filing of the petition in bankruptcy on the following February 2nd.

In this state of facts, if the fund or property attached had remained in possession of the attaching officer up to the time of the filing of the petition, there would be no question but that the Trustee would be entitled to prevail. The question thus is limited to this: Does the voluntary payover of the funds by the levying officer to the attaching creditor, in the absence of judgment or judicial sale, prevent the Trustee from reaching the property levied upon?

The position of Bacon is that there is no lien to be destroyed and thus the property cannot be reached under the terms of Section 67 of the Bankruptcy Act. The authority cited is referenced to text material, which material is in turn supported by formal judgment and execution sale prior to bankruptcy, and ordinarily involve the rights of bona fide purchasers at such sale. They do not involve a voluntary transfer of the fund or property attached by arrangement with the debtor. The cited cases also were decided under the prior wording of Section 67(f) as distinguished from Section 67(a) of the present Act. The important distinction between Section 67(f) in the 1898 Act and as amended in 1934 and the present Section 67(a), is that the prior sections provided that title of a bona fide purchaser who acquired property subject to an invalid attachment lien would not be destroyed. In other words, someone buying the property that had been subjected to this invalid levy, would get good title in any event. However, the word-

ing of the present statute provides in Section 67(a) (3):

“... Provided, however, That the title of a bona fide purchaser of such property shall be valid, but if such title is acquired otherwise than at a judicial sale held to enforce such lien, it shall be valid only to the extent of the present consideration paid for such property.”

Therefore, for the first time, the section recognized that there might be acquisition of title to property that had been subjected to an invalid attachment lien by a bona fide purchaser at other than a judicial sale, and limited the title of such purchaser to the actual consideration presently paid. The prior statutes would have protected such a purchaser entirely.

The second addition to Section 67(a) as it now exists compared to the old Section 67(f), is that liens sought and permitted in fraud of the provisions of this Act are likewise invalidated. In other words, if the attachment lien or judicial lien did not technically qualify under Section 67(a)(1)(a) as voidable by the Trustee (the typical attachment within four months, while insolvent), it would or could be set aside if there was an element of fraud present which would permit a creditor to place himself in a preferred position at the expense of the other creditors.

These two additions to Section 67(a), compared to the predecessor sections, indicate the increasing awareness of the Congress that judicial lien procedures could be used as a way of enforcing preferential payment in such manner as to avoid the impact of

Section 60 of the Bankruptcy Act, which is the usual preference section. A typical example of how judicial lien procedure can be used to avoid preference is illustrated in the following set of circumstances: A creditor attaches and thus obtains an attachment lien, within four months prior to bankruptcy, followed by a voluntary acquiescence of the debtor in the payover by the levying officer of the fund attached, to the attaching creditor. By the use of this device, a creditor can contend that the lien of the attachment was destroyed by the voluntary payover, thus avoiding Section 67 and at the same time avoiding the impact of Section 60 (the preference section) since there was no receipt of funds directly from the bankrupt to the creditor. This is the thing that occurred in this case. After attachment but before bankruptcy, the creditor obtained a voluntary release from the bankrupt permitting the levying officer to pay over the funds to the attaching creditor. By dint of this stratagem the creditor now contends that he is free from both Section 60 and Section 67. We submit that it is just this type of situation that the two additions to Section 67(a) above set out were designed to cure.

In order that the relative provisions of Section 67(f) of the original Bankruptcy Act, the provisions of Section 67(f) pursuant to the act of June 7, 1934, and the present provisions can be readily compared, they are set forth as Appendices A, B, and C hereto.

The entire theory of the bankruptcy law is that all general unsecured creditors will be given equal treatment and transfers made which would prefer

one creditor over another are voidable. Section 60. Transfers made without adequate consideration which would operate to deprive the general creditors of complete pro-rata distribution are made fraudulent. Section 67, Section 70. The Congress realizes that persons preparing for bankruptcy may seek to take care of their friends by voluntary consent arrangements, at the expense of other creditors, and Congress has accordingly vitiated certain acts done or suffered to be done within four months prior to the filing of a petition. Section 60 and Section 67. The Congress also realizes that the distressed status of the debtor ordinarily becomes apparent to his creditors prior to his actually filing a petition, and has accordingly given general creditors a means of protecting themselves against the aggressive creditor who seeks to have his claim paid in full, while others must accept less than all. Section 67. Indeed the obtaining of an attachment lien by a creditor on property of the debtor gives the other creditors of the bankrupt the right to file an involuntary petition to make sure that the attaching creditor does not become fully paid while they do not. Section 3.

Thus it is apparent that the entire theory of the bankruptcy proceeding is that all creditors be treated fairly; that the acts of the bankrupt to attempt to prefer one creditor over another shall be disregarded; that attempts by certain of the creditors to gain advantage over the others will be set aside.

The Appellant must concede that except for the transfer of the funds from the Sheriff of Mendocino

County to the attaching creditor, that Section 67(a) would vitiate its lien, and the Trustee would be fully entitled to prevail. It contends, however, that this transfer of funds to the creditor overturns the entire Bankruptcy Act and its provisions and allows Appellant to now have that which it could not have obtained had the funds been in the hands of the Sheriff. The question then becomes: Can a creditor by thus obtaining funds through the enforcement of his void attachment lien, defeat the purposes of the Act?

The Trustee invites the attention of the Court to Section 67(a)(1)(b). That section would vitiate any liens sought or permitted in fraud of the provisions of the Act, as well as merely avoiding liens established within four months prior to bankruptcy, while the bankrupt was insolvent. The facts admittedly demonstrate that the Appellant received 100% payment of its claim, at a time when, as the evidence indicates, the bankrupt could not pay the remainder of its creditors in the same ratio. If Appellant Bacon is thus allowed to retain the result of the enforcement of the invalid lien, it will have destroyed the aim of the Bankruptcy Act seeking to achieve equality, and will have allowed Bacon to make valid an attachment lien which is admittedly otherwise invalid. The law should not be thus subverted.

In addition to the provisions of Section 67(a)(1)(a) and (b), the Congress has enacted subsections (2) and (3), permitting the Trustee to nullify transfers of property to sureties or third persons to obtain the discharge or dissolution of an attachment lien.

If the lien is affected by Section 67(a)(1), then any property posted or given or transferred to obtain the dissolution or discharge of the attachment writ can also be followed by the Trustee and recovered. The only limitation on the capacity of the Trustee to pursue the property after the lien has been discharged is where the property has found its way into the hands of a bona fide purchaser at a judicial sale, the title of the third person is good only to the extent of the present consideration paid for the transfer. If the transfer, therefore, of the funds from the hands of the Sheriff, to any creditor is permitted in order to obtain a dissolution of the attachment lien without judgment having been obtained against the debtor and without execution levied or without execution sale, then the title of the recipient of the fund or the property would be good under Section 67(a)(3) only to the extent of the present consideration paid. Here there was no present consideration paid. The only consideration conceivably involved in the transfer of funds from the Sheriff to Bacon was an antecedent, as distinguished from a present, debt or consideration.

It often happens that attachment liens are discharged by the posting of security or the transfer of property for various reasons other than the confession of the debt with the payment thereof. One of those reasons is reflected in Section 3 of the Bankruptcy Act. If the debtor does not discharge the attachment or obtain the dissolution within thirty days, the debtor becomes vulnerable to having an involuntary petition in bankruptcy filed against him. Many times, the

debtor wishes to avoid this result and for that reason suffers money to be paid over in order to dissolve an attachment. Clearly such a voluntary transfer is part and parcel of the enforcement of the lien by the creditor and should be avoided by Section 67 of the Act, and the subsections above noted.

If, as is provided in Paragraphs 2 and 3 of Section 67(a), the Trustee can recover property given to effect the discharge or dissolution of an attachment lien, except as to bona fide purchasers, why would the Trustee not be permitted to recover the same property given to the creditor to obtain dissolution of the attachment lien where the transfer was voluntary and without force of judgment.

All of the cases supporting the text material cited by Bacon deal with situations where the lien was enforced through judicial sale and payover prior to bankruptcy, or situations where the lien was invalidated for failure to turn over the funds in this manner. This is to be distinguished from a situation where property is voluntarily transferred to effect a dissolution of an attachment lien prior to judgment. The latter situation more closely correlates to Section 67 (a) (2) and (3) and would appear to be covered under Section 67 (a) (1) (b) as a lien sought and permitted in fraud of the provisions of this Act.

The only case treating a situation where there was a transfer to the creditor to effect a discharge of an attachment lien, as distinguished from a judicial sale after judgment is *Howarth v. Universal C.I.T. Credit Corporation*, 203 Fed. Supp. 279. The Court states on page 282 as follows:

“Spohn’s bank account at the People’s First National Bank and Trust Company in the sum of \$6,734.21 was garnisheed and transferred to U.C.I.T. pursuant to a writ of attachment execution issued on a judgment in favor of U.C.I.T. in the sum of \$75,000.00. The lien against the bank cash obtained by the attachment within four months of bankruptcy, and while Spohn was insolvent, is null and void. Section 67, Bankruptcy Act.”

This holding would appear to support our analysis of what the result in this case should be. To allow a creditor to enforce an attachment lien by accepting a transfer of property or funds voluntarily, all within four months prior to bankruptcy and while the debtor is insolvent, would be to open an avenue to creditors particularly in situations where the bankrupt would cooperate, or had a reason to have the attachment liens dissolved, to avoid completely and nullify the effect of Section 67 of the Bankruptcy Act. We submit that the entire Section 67 (a), including (a) (1) (b) and (2) and (3) requires a holding that this stratagem cannot be used to defeat the purposes of the Bankruptcy Act.

Dated, Eureka, California,
October 22, 1968.

Respectfully submitted,
FREDERICK L. HILGER,
Attorney for Appellee.

(Appendices A, B and C Follow)



Appendices A, B and C



Appendix A

Bankruptcy Act, §67(f) as originally enacted:

“That all levies, judgments, attachments, or other liens, obtained through legal proceedings against a person who is insolvent, at any time within four months prior to the filing of a petition in bankruptcy against him, shall be deemed null and void in case he is adjudged a bankrupt, and the property affected by the levy, judgment, attachment, or other lien shall be deemed wholly discharged and released from the same, and shall pass to the trustee as a part of the estate of the bankrupt, unless the court shall, on due notice, order that the right under such levy, judgment, attachment, or other lien shall be preserved for the benefit of the estate; and thereupon the same may pass to and shall be preserved by the trustee for the benefit of the estate as aforesaid. And the court may order such conveyance as shall be necessary to carry the purposes of this section into effect: Provided, That nothing herein contained shall have the effect to destroy or impair the title obtained by such levy, judgment, attachment, or other lien, of a bona fide purchaser for value who shall have acquired the same without notice or reasonable cause for inquiry.”

Appendix B

An Act June 7, 1934, amended §67(f) to read as follows:

“That all levies, judgments, attachments, or other liens, obtained through legal proceedings against a person who is insolvent, at any time within four months prior to the filing of a petition in bankruptcy against him, and any bond which may be given to dissolve any such lien so created, shall be deemed null and void in case he is adjudged a bankrupt, and the property affected by the levy, judgment, attachment, or other lien, and any nonexempt property of his which he shall have deposited or pledged as security for such bond or to indemnify any surety thereon, shall be deemed wholly discharged and released from the same, and shall pass to the trustee as a part of the estate of the bankrupt, unless the court shall, on due notice, order that the right under such levy, judgment, attachment, or other lien shall be preserved for the benefit of the estate; and thereupon the same may pass to and shall be preserved by the trustee for the benefit of the estate as aforesaid. And the court may order such conveyance as shall be necessary to carry the purposes of this section into effect: Provided, That nothing herein contained shall have the effect to destroy or impair the title obtained by such levy, judgment, attachment, or other lien, of a bona fide purchaser for value who shall have acquired the same without notice or reasonable cause for inquiry.”

Appendix C

Bankruptcy Act, Section 67 (a) as amended, is now as follows:

“Sec. 67. Liens and Fraudulent Transfers.—a (1) Every lien against the property of a person obtained by attachment, judgment, levy, or other legal or equitable process or proceedings within four months before the filing of a petition initiating a proceeding under this Act by or against such person shall be deemed null and void (a) if at the time when such lien was obtained such person was insolvent or (b) if such lien was sought and permitted in fraud of the provisions of this Act: *Provided, however,* That if such person is not finally adjudged a bankrupt in any proceeding under this Act and if no arrangement or plan is proposed and confirmed, such lien shall be deemed reinstated with the same effect as if it had not been nullified and voided.

“(2) If any lien deemed null and void under the provisions of paragraph (1) of this subdivision a, has been dissolved by the furnishing of a bond or other obligation, the surety on which has been indemnified directly or indirectly by the transfer of or the creation of a lien upon any of the nonexempt property of a person before the filing of a petition initiating a proceeding under this Act by or against him, such indemnifying transfer or lien shall also be deemed null and void: *Provided, however,* That if such person is not finally adjudged a bankrupt in any proceeding under this Act, and if no arrangement or plan is proposed

and confirmed, such transfer or lien shall be deemed reinstated with the same effect as if it had not been nullified and voided.

“(3) The property affected by any lien deemed null and void under the provisions of paragraphs (1) and (2) of this subdivision a shall be discharged from such lien, and such property and any of the indemnifying property transferred to or for the benefit of a surety shall pass to the trustee or debtor, as the case may be, except that the court may on due notice order any such lien to be preserved for the benefit of the estate, and the court may direct such conveyance as may be proper or adequate to evidence the title thereto of the trustee or debtor, as the case may be: *Provided, however,* That the title of a bona-fide purchaser of such property shall be valid, but if such title is acquired otherwise than at a judicial sale held to enforce such lien, it shall be valid only to the extent of the present consideration paid for such property.

“(4) The court shall have summary jurisdiction of any proceeding by the trustee or debtor, as the case may be, to hear and determine the rights of any parties under this subdivision a. Due notice of any hearing in such proceeding shall be given to all parties in interest, including the obligee of a releasing bond or other like obligation. Where an order is entered for the recovery of indemnifying property in kind or for the avoidance of an indemnifying lien, the court, upon application of any party in interest, shall in the same proceeding ascertain the value of such property

or lien, and if such value is less than the amount for which such property is indemnity or than the amount of such lien, the transferee or lienholder may elect to retain such property or lien upon payment of its value, as ascertained by the court, to the trustee or debtor, as the case may be, within such reasonable times as the court shall fix.

“(5) The liability of a surety under a releasing bond or other like obligation shall be discharged to the extent of the value of the indemnifying property recovered or the indemnifying lien nullified and voided by the trustee or debtor, or, where the property is retained pursuant to the provisions of paragraph (4) of this subdivision a, to the extent of the amount paid to the trustee or debtor.”





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COMMODITIES EXCHANGE ACT**Section 2(a) (7 U.S.C.A. § 4)****Liability of principal for act of agent**

For the purpose of this chapter the act, omission, or failure of any official, agent, or other person acting for any individual, association, partnership, corporation, or trust within the scope of his employment or office shall be deemed the act, omission, or failure of such individual, association, partnership, corporation, or trust, as well as of such official, agent, or other person.

Section 4b (7 U.S.C.A. § 6b)**Contracts designed to defraud or mislead**

It shall be unlawful for any member of a contract market, or for any correspondent, agent, or employee of any member, in or in connection with any order to make, or the making of (1) any contract of sale of any commodity in interstate commerce, or (2) any contract of sale of any commodity for future delivery made, or to be made, on or subject to the rules of any contract market for or on behalf of any person if such contract for future delivery is or may be used for (a) hedging any transaction in interstate commerce in such commodity or the products or by-products thereof, or (b) determining the price basis of any transaction in interstate commerce in such commodity, or (c) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof—

(A) to cheat or defraud or attempt to cheat or defraud such person;

(B) willfully to make or cause to be made to such person any false report or statement thereof, or wilfully to enter or cause to be entered for such person any false record thereof;

(C) willfully to deceive or attempt to deceive such person by any means whatsoever in regard to any such order or contract or the disposition or execution of any such order or contract, or in regard to any act of agency performed with respect to such order or contract for such person. . . .

Section 9 (7 U.S.C.A. § 13)**Violations generally; false reports; punishment**

Any person who shall violate the provisions of sections 6-6e, 6h, or 6i of this title, or who shall manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any board of trade . . . shall be deemed guilty of a misdemeanor, and upon conviction thereof be fined not more than \$10,000 or imprisoned for not more than one year; or both, together with the costs of prosecution.

SECURITIES ACT OF 1933**Section 2 (15 U.S.C.A. § 77b)****Definitions**

When used in this subchapter, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

* * *

(3) The term "sale" or "sell" shall include every contract of sale or disposition of a security or interest in a security, for value. The term "offer to sell", "offer for sale", or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.

Section 14 (15 U.S.C.A. § 77n)**Contrary stipulations void**

Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.

Section 16 (15 U.S.C.A. § 77p)**Additional remedies**

The rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.

Section 17 (15 U.S.C.A. § 77q)**Fraudulent interstate transactions**

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud,
or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 22 (15 U.S.C.A. § 77v)**Jurisdiction of offenses and suits**

(a) The district courts of the United States, and the United States courts of any Territory, shall have jurisdiction of offenses

and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter.

SECURITIES EXCHANGE ACT OF 1934

Section 3 (15 U.S.C.A. § 78c)

Definitions and application—Definitions

(a) When used in this chapter, unless the context otherwise requires—

* * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

* * *

(13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.

(14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of.

Section 10 (15 U.S.C.A. § 78j)**Manipulative and deceptive devices**

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 20 (15 U.S.C.A. § 78t)**Liabilities of controlling persons**

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person.

Section 27 (15 U.S.C.A. § 78aa)**Jurisdiction of offenses and suits**

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28.

**RULES OF FAIR PRACTICE OF THE NATIONAL ASSOCIATION
OF SECURITIES DEALERS, INC. AS EXCERPTED FROM THE
NASD MANUAL****Article III****Business Conduct of Members****Sec. 1.**

A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

Recommendations to Customers**Sec. 2.**

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for be-

believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

* * *

Discretionary Accounts

Sec. 15.

Excessive transactions

(a) No member shall effect with or for any customer's account in respect to which such member or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

Authorization and acceptance of account

(b) No member or registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization to a stated individual or individuals and the account has been accepted by the member, as evidenced in writing by the member or the partner, officer or manager, duly designated by the member, in accordance with Section 27 of these rules.

Approval and review of transactions

(c) The member or the person duly designated shall approve promptly in writing each discretionary order entered and shall review all discretionary accounts at frequent intervals in order to detect and prevent transactions which are excessive in size or frequency in view of the financial resources and character of the account.

* * *

Use of Fraudulent Devices

Sec. 18.

No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.

* * *

Supervision**Sec. 27.****Written procedures**

(a) Each member shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association.

Responsibility of member

(b) Final responsibility for proper supervision shall rest with the member. The member shall designate a partner, officer or manager in each office of supervisory jurisdiction, including the main office, to carry out the written supervisory procedures. A copy of such procedures shall be kept in each such office.

Written approval

(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

. . . Policy of the Board of Governors**Fair Dealing With Customers**

Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's rules, with particular emphasis on the requirement to deal fairly with the public.

This does not mean that legitimate sales efforts in the securities business are to be discouraged by requirements which do not take into account the variety of circumstances which can enter into the member-customer relationship. It does mean, however, that sales efforts must be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers.

District Business Conduct Committees and the Board of Governors have interpreted the Rules of Fair Practice, taken disciplinary action and imposed penalties in many situations where members' sales efforts have exceeded the reasonable grounds of fair dealing.

Some practices that have resulted in disciplinary action and that clearly violate this responsibility for fair dealing are set forth below, as a guide to members:

Recommending Speculative Low-priced Securities

1. Recommending speculative low-priced securities to customers without knowledge of or attempt to obtain information concerning the customers' other securities holdings, their financial situation and other necessary data. The principle here is that this practice, by its very nature, involves a high probability that the recommendation will not be suitable for at least some of the persons solicited. This has particular application to high pressure telephonic sales campaigns.

Excessive Trading Activity

2. Excessive activity in a customer's account, often referred to as "churning" or "overtrading." There are no specific standards to measure excessiveness of activity in customer accounts because this must be related to the objectives and financial situation of the customer involved.

* * *

Fraudulent Activity

4. Numerous instances of fraudulent conduct have been acted upon by the Association and have resulted in penalties against members. Among some of these activities are:

* * *

Discretionary Accounts

- (b) Transactions in discretionary accounts in excess of or without actual authority from customers.

Unauthorized Transactions

- (c) Causing the execution of transactions which are unauthorized by customers or the sending of confirmations in order to cause customers to accept transactions not actually agreed upon.

Misuse of Customers' Funds or Securities

- (d) Unauthorized use or borrowing of customers' funds or securities.

Private Transactions

- (e) Transactions by registered representatives which are concealed from their employers or securities transactions outside registered representatives' regular employment, even if disclosed to their employers, if such transactions are in violation of Federal or State law.

In addition, other fraudulent activities, such as forgery, non-disclosure or misstatement of material facts, manipulations and various deceptions, have been found in violation of Association rules. These same activities are also subject to the civil and criminal laws and sanctions of Federal and State Governments.

While most members are fully aware of the fairness required in dealing with customers, it is anticipated that these enumerated practices, which are not all inclusive, will be of future assistance in the training and education of new personnel.

The Securities and Exchange Commission has also recognized that brokers and dealers have an obligation of fair dealing in actions under the general anti-fraud provisions of the Federal securities laws. The Commission bases this obligation on the principle that when a securities dealer opens his business he is, in effect, representing that he will deal fairly with the public. Certain of the Commission's cases on fair dealing involve practices not covered in the foregoing illustrations. Usually, any breach of the obligation of fair dealing as determined by the Commission under the anti-fraud provisions of the securities laws could be considered a violation of the Association's Rules of Fair Practice.

NEW YORK STOCK EXCHANGE RULES AS EXCERPTED FROM THE CCH NYSE GUIDE, VOLUME 2, (1962)

Conduct of Accounts

*(Rules and Policies Administered by the
Department of Member Firms.)*

§ 2401—Business Conduct

Rule 401. Every member, allied member and member organization shall at all times adhere to the principles of good business practice in the conduct of his or its business affairs. (Page 3695)

§ 2405—Diligence as to Accounts

Rule 405. Every member organization is required through a general partner or an officer who is a holder of voting stock to

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

Supervision of Accounts

(2) Supervise diligently all accounts handled by registered representatives of the organization.

Approval of Accounts

(3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a general partner or an officer who is a holder of voting stock in the organization. The member, general partner or officer approving the opening of the account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization. (Page 3700)

Miscellaneous Rules and Provisions

*(Rules and Policies Administered by the
Department of Member Firms.)*

§ 2435—Miscellaneous Prohibitions

Rule 435. No member, member organization, partner or stockholder therein shall:

Excessive trading by members

(1) Effect on the Exchange purchases or sales for any account in which he or it is directly or indirectly interested, which purchases or sales are excessive in view of his or its financial resources or in view of the market for such security.

Excessive trading in discretionary accounts

(2) Execute or cause to be executed on the Exchange purchases or sales of any stock for any account with respect to which he or it or another partner or stockholder therein is vested with any discretionary power, which purchases or sales are excessive in size or frequency in view of the financial resources in such account.
(Page 3775)



✓ ✓

Nos. 22,971 and 23,017
IN THE
United States Court of Appeals
For the Ninth Circuit

*See last
of this Vol.
for
additional papers*

FEB 20 1969

BERTHA HECHT,

*Plaintiff, Appellee and
Appellant,*

vs.

HARRIS, UPHAM & Co., a partnership,

HARRIS, UPHAM & Co., INC., a corporation,
*Defendants, Appellants and
Appellees.*

BRIEF ON APPEAL OF DEFENDANTS
HARRIS, UPHAM & CO., ET ANO — No. 22,971
and their
RESPONSIVE BRIEF TO PLAINTIFF'S
"OPENING BRIEF" ON APPEAL—No. 23,017

EMANUEL BECKER,

40 Wall Street,

New York, N.Y. 10005,

THOMAS A. H. HARTWELL,

COOLEY, CROWLEY, GAITHER,

GODWARD, CASTRO & HUDDLESON,

The Alcoa Building, 1 Maritime Plaza,

San Francisco, California 94111,

Attorneys for Defendants

Harris, Upham & Co., et ano.

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Nos. 22,971 and 23,017

IN THE

**United States Court of Appeals
For the Ninth Circuit**

BERTHA HECHT,

*Plaintiff, Appellee and
Appellant,*

vs.

HARRIS, UPHAM & Co., a partnership,
HARRIS, UPHAM & Co., INC., a corporation,
*Defendants, Appellants and
Appellees.*

BRIEF ON APPEAL OF DEFENDANTS

HARRIS, UPHAM & CO., ET ANO — No. 22,971

THE ISSUES

1. Do the federal courts, absent diversity of citizenship, have jurisdiction in an action for "breach of fiduciary obligations"? Should the complaint, as detailed by the plaintiff's pretrial statement, have been dismissed at pretrial?

2. Is Rule 10b-5¹ promulgated under the Securities Exchange Act, or any other federal law, invoked by an allegation with regard to the trading of

¹Please note our addendum *infra* setting forth relevant statutes and rules.

commodities by an elderly lady; and having regard for the other allegations of the complaint, was the District Court privileged to consider this claim or the theory of pendant jurisdiction?

3. The court below found that plaintiff knew and understood at the time they occurred all the activities about which she now complains, that she permitted them to continue for eight years and that she led Harris, Upham & Co. (hereinafter referred to as Harris Upham) to rely on her apparent satisfaction. Plaintiff claims she was dissatisfied, distrusted her registered representative, and knew that all her instructions were being violated and her interests ignored from the very first. Do these findings require judgment as matter of law that (1) the Security Acts were not violated, and (2) that plaintiff is now barred from seeking relief because of laches, waiver and estoppel and the Statute of Limitations?

4. Absent a finding that plaintiff was misled, is "excessive trading" of securities over national exchanges a violation of Rule 10b-5 of the Securities and Exchange Commission promulgated pursuant to Section 10(b) of the Securities Exchange Act? Are the court's findings sufficient in law to establish a cause of action under Rule 10b-5, and are they supported by evidence?

5. Is Harris Upham liable for "bad faith" and "participation" under Section 20(a) of the Securities Exchange Act because its resident partner failed personally to meet and know the plaintiff?

6. Are the damages awarded in excess of those permitted under Section 28(a) of the Securities Exchange Act? Are the court's awards of damages supported by any evidence? Is there any evidence that violation of the Security Acts, if any, was the proximate cause of her damage or any part thereof? Is not plaintiff barred from recovering the damages awarded in whole or part by her laches, waiver and estoppel, and the Statute of Limitations?

7. As to two transactions herein referred to as "Itek" and "Colonial" in which plaintiff and her registered representative privately engaged:

a) Was the court privileged to find liability against Harris Upham in its first memorandum of decision, after excluding such proof against it during the trial, without first giving Harris Upham an opportunity to cross-examine, and offering evidence with respect thereto? Was the court barred by its prejudgment from later entering a judgment with respect to these transactions?

b) Does the Statute of Limitations bar relief with respect to transactions (Itek and Colonial) not pleaded and with respect to which proof was first offered more than three years after plaintiff by her own admission (Par. 17, complaint) was fully aware of all the facts?

c) Does the Colonial transaction, as found by the court, constitute a violation of Rule 10b-5?

d) Is Harris Upham liable for unauthorized private dealings between plaintiff and its registered rep-

representative in which Harris Upham did not participate or profit and of which Harris Upham had no knowledge, especially in view of the fact that the registered representative was barred from conducting such private dealings under the rules of the New York Stock Exchange to which he subscribed?

Judgment was entered against Harris, Upham & Co. Inc., a corporation not in existence at any time here in issue. No evidence of its assumption of liability was tendered. This is not a disputable issue. The judgment against it should be reversed.

STATEMENT OF THE CASE

The Parties

The parties to the action in the court below were plaintiff Bertha Hecht; Asa V. Wilder; Harris, Upham & Co., a partnership, some of its partners, and Harris, Upham & Co. Inc. Judgment was entered against Wilder, the partnership and the corporation.

Wilder has not appealed. Appellants (called defendant herein) are the partnership and the corporation. Bertha Hecht was a customer of Asa V. Wilder, beginning with 1955, while he was associated with the brokerage firm of Hooker & Fay. Asa V. Wilder became a registered representative of Harris, Upham & Co. on May 1, 1957, and brought with him Mrs. Hecht's account. Harris, Upham & Co. was a partnership engaged in the brokerage business. It did not hold itself out as an investment adviser, and did not

sell or purchase securities for its own account (R. 590-94, 623-29, 709, 710);² it acted exclusively as an agent for its customers in purchasing and selling securities.

The Pleadings

The complaint does not allege that at any time between May 1, 1957 and March 1964 (when Mrs. Hecht withdrew her account) Harris Upham or anybody else acting on its behalf withheld or misrepresented fact, or misled plaintiff to her damage, that she was "defrauded" in any sense that the word "fraud" might conceivably be interpreted under the Security Acts (T. 1, et seq.). The action and the relief sought are for breach of trust which came into being between plaintiff and Wilder two years before Mrs. Hecht and Wilder came to Harris Upham, not for violation of the Security Laws. The caption of the complaint states it is both. "Excessive trading" of securities is alleged as a breach of trust, not as an act which misled plaintiff. No damages are claimed to have been suffered (the account was profitable); commissions paid are demanded as if they were trustee fees. They are duplicative of the far greater damages sought for breach of trust, to wit, that plaintiff be put in status quo, as if she had not knowingly engaged for a period of seven years in trading securities and commodities through Harris Upham.

²"T." refers to the Clerk's transcript; "R." to the stenographic record of the reporters in the court below.

Defendant's answer, in addition to a general denial, raises the issues of waiver, ratification³, estoppel, laches and Statute of Limitations.

Plaintiff rewrote her pretrial statement on numerous occasions. She maintained her posture of bringing an action for a breach of the trust with Wilder rather than for fraud, misrepresentation, or a plaintiff misled to her damage at any time by Harris Upham or its "controlled persons". The relief sought remained the same. In its final form the pretrial statement alleged plaintiff's combined trading of securities and commodities was "excessive" (T. 241) but not "excessive" by any standard provided by statute or regulation. It did not claim her security trading alone was "excessive" by any standard.

Plaintiff's pretrial statement absolved Harris Upham of any knowledge of the private arrangements between plaintiff and Wilder (T. 68 and 69) and stated her account was not discretionary (T. 69).⁴ Harris Upham was not charged with the knowledge of plaintiff's entrustment of her assets to Wilder in 1955, two years before Wilder's association with it, nor with the "conspiracy" by Wilder presumably formed in 1955 to deprive plaintiff of her assets (T. 244). No fact was stated from which it could be inferred that Harris Upham acted in "bad faith" or "participated" in Wilder's "breach of fiduciary duty."

³By amendment at pretrial.

⁴This pretrial statement, one of many, is incorporated by reference in later pretrial statements (T. 245, 365).

Pretrial Proceedings

Defendant moved at the first pretrial conference to dismiss the complaint for lack of jurisdiction. The court refused to consider the motion at that time⁵ or at the numerous conferences thereafter. Defendant's pretrial statements repeated and briefed the absence of jurisdiction and the limits of pendant jurisdiction, and requested the court so to limit the trial, if jurisdiction were retained, especially since a jury trial was then contemplated (T. 219, et seq., 1167, et seq.). The pretrial order of the court specifically recites that the court refused to consider these issues (T. 363). The motion to dismiss was renewed at the opening of the trial, after plaintiff testified, and upon the conclusion of plaintiff's case. The court reserved decision.

Objections to the court's consideration of commodities on the ground of lack of jurisdiction was also made during the trial (R. 1118-21).

The Court's Memoranda of Decision

The court filed two memoranda of decision. In the first it granted judgment against defendant for all commissions paid by plaintiff to Harris Upham for securities and commodities transactions and for interest paid by her on her "margin" account, on the ground that these accounts were "churned" (T. 906, et seq.). It also granted judgment for moneys received

⁵Counsel for the plaintiff was invited by the court to recite the complaint allegations which would invoke federal jurisdiction. Apparently satisfied there were none, the court pronounced "a plague on both your houses." (Transcript of hearing, Feb. 2, 1967, pp. 30-56).

by Wilder in private dealings between him and Mrs. Hecht in transactions hereinabove referred to as the "Itek" and "Colonial" transactions. It acknowledged evidence of these transactions was not admitted against Harris Upham during the trial,⁶ and invited a tender of proof (T. 950).

Defendant moved to set aside that portion of the decision which related to Itek and Colonial, on the grounds that (1) they were not alleged in the complaint or in the pretrial statement; (2) they were first put in issue after they were barred by the three-year Statute of Limitations (R. 4745-4749); the complaint confessed to full knowledge of all facts in March 1964 (para. 17); (3) the evidence had not been admitted against Harris Upham, and it had no opportunity to cross-examine or to offer evidence; (4) the private transactions between Mrs. Hecht and Mr. Wilder were without authority of Harris Upham; (5) no pretrial proceedings had been had and witnesses were no longer available. Defendant also moved to set side the decision of the court on the ground that it was based on the character of the relationship between plaintiff and Wilder and plaintiff's business understanding, which in large part had been determined by these facts not admitted against Harris Upham (R. 4734-4736; 4745 et seq.).

At the same hearing an agreement signed by Wilder pursuant to Stock Exchange Regulation was offered and admitted in evidence (R. 4737-4739; Ex. A). It

⁶R. 3459, 3460, 3468, 3482, 3502, 3509, 3512, 3513, 3526, 3586, 3591.

provides that a "registered representative" may not engage in private transactions with a customer or accept gifts.

Plaintiff moved at the same time to increase damages.

The court filed an amended memorandum of decision. It did not advert to defendant's motions. It granted further damages to the plaintiff for the following (T. 994, et seq.):

(a) Net losses suffered by the plaintiff in her commodities account over seven years in the amount of \$78,000;

(b) \$65,000 which might have been earned by the plaintiff if she had not transferred \$245,000 from her securities account to her commodities account over a period of seven years. The average amount maintained by Mrs. Hecht in her commodities account was assumed by the court in another finding to be \$35,000 (T. 1040)⁷;

(c) Interest on its original judgment for commissions, and interest charges on the margin account paid to Harris Upham.

THE FACTS

The Plaintiff

Although the court below predicated its decision on the "comprehension" of the plaintiff, it does not appear to have relied on her testimony, but rather

⁷"The commodities account, assuming an average investment of \$35,000." Some moneys were also transferred back (Exh. 324).

on "inference" unsupported by fact. It was seriously handicapped in finding fact by plaintiff's extraordinary prevarication. Its opinion adverts to her "occasional evasions and exaggerations and her casual bragging to others of her market knowledge and success" (T. 1034), but that does not fairly reflect the record.

Two doctors appeared to testify on her behalf. One had treated her for toxic poisoning in 1955 (R. 769-70). The other was her doctor from 1959 to the time he testified; he saw her frequently. Both of them testified Mrs. Hecht does not tell the truth and her memory suits her convenience (R. 321, 345, 346, 376, 759, 760, 776). She readily blames others for her difficulties, claiming they "forced" her (R. 777-779).

Her testimony confirms the opinions of her doctors. She spoke to her broker every morning and sometimes more often, but insisted that the only matters discussed were the weather and the inadequate train service between San Mateo and San Francisco (R. 2486). A former school teacher who had taught the Roman numeral system and reads extensively, plaintiff did not know what the letter "M" stood for, even in statements which she had prepared (R. 2508, 2918, 3015). Nor did she consistently know what the words "due", "bale", "buy", "sell" or "diversify" meant (R. 2420, 2663-64, 2683, 2918, 2967). She outlined very clearly the nature of convertible debentures (R. 2856); then under the guidance of her counsel explained that "convertibles" related to automobiles (R. 2909-10). She claimed that her eyes were too poor to

read market quotations, but admitted following the horses by reference to jockeys whose names appear in even smaller type in her local newspaper (R. 2696, 2750). The list could be enlarged (R. 2850-51, 2861-62, 2910, 2935-36, 2952, et seq.).

The doctor who treated her in 1955 disclaimed reason to believe Mrs. Hecht was not capable of being a successful business woman (R. 787-789). Her present doctor stated that she was sane, smart and had a much better grasp of financial affairs than he had (R. 304, 317, 323, 342, 343, 361, 363). She was more interested in such matters (R. 340, 363). Both agreed she is suspicious and distrustful of others, and did not listen to or follow advice, except when it suited her (R. 312, 314, 327-329, 779). She had a mind of her own (R. 312, 329, 779).

The court's opinion of Mrs. Hecht's abilities and attitudes was based upon observation made in 1967 when she was 77 years old, and whatever their value cannot be deemed to be of significance with regard to her emotional state and understanding between 1955 and 1964. Her present doctor's opinion was she knew what she was doing (R. 341-43, 361); Mrs. Hecht was of that opinion before instituting action (R. 1866, 2786-88, 3328-36).

Plaintiff's Knowledge, and Her Participation in Trading Her Account Before 1955

Plaintiff admitted she reads financial columnists, company writeups in the Wall Street Journal, annual stockholders reports, and the like (R. 2509-10, 2780, 2910) and demonstrated on the witness stand her

ability to read financial, security and commodity statements (R. 2528, 2592-93, 2703-7, 2774-76, 2836, 2863-64, 2907, 2960-63, 2972-73). She searched the newspapers for "buys" (R. 2689).

She had a brokerage account in 1928 or earlier; it was then and continuously thereafter (to 1964) a margin account (R. 1072, 2431-33, 2521, 2592-93); she responded to a margin call in 1928 (R. 2514-15); she remembered the 1929 crash well and the losses suffered by people at that time (R. 2517); she actively traded securities in the 1930s, and kept her own records (R. 2523, 2534, 2707, 2847, 2863, 4330). She recalled the names of the companies and the businesses in which they were engaged (R. 2504-05, 2519, 2527, 2534). She received advice but insists she always made her own decisions (R. 2525, 2534, 2683-85). A record of one year sales in the 1930s shows some of her trades were overnight purchases and sales or of short duration; some of them were for extended periods (R. 2504, 4329, 4330; Exs. 24, 26). Her "turnover" for the size of her account far exceeded the turnover at Harris Upham (R. 4330; compare Exs. 24, 26 and 291).

In 1956 plaintiff wrote a letter introducing a young man to Mr. Wilder. She stated that he, unlike her, did not know the "risks" of the market (R. 361, 2742, Ex. QQQ). In testifying she referred to "gambling on" and "playing" the market (R. 2750). She was well aware of the speculative risk in excessive margin (R. 2521). She admitted her lawyer who handled her interest in her husband's estate warned her that she

could "lose her shirt" in commodities (R. 2544) and that her husband opposed her speculating in commodities (R. 2543). He was in the commodities business and maintained a "future" commodities account with Merrill Lynch, Pierce, Fenner & Beane. Her brother-in-law, she admitted, did not "hold with" trading in commodities (R. 2628, 2629). She testified that she did not approve of speculation in commodities by persons who could not afford it (R. 2733-36). She knew she was putting money into commodities from time to time (R. 2406).

Plaintiff had opinions with respect to different types of securities, metals, oils, utilities and the like (R. 2670-74) and remembered the reasons for her various purchases in the 1930s. She testified to the importance of management in appraising a security (R. 2673). She presently has an investment adviser with whom she consults regularly, but she also talks to her broker (R. 2655). Her account is not discretionary (R. 2655) and she disapproves of trusts (R. 1992, 2955, 2894). She admitted to a long held interest in gambling. In earlier years she bet on dog races and horse races (R. 2518, 2749, 2750). One of her current forms of self entertainment is "handicapping" horses (R. 2286).

Plaintiff's testimony is confirmed by her broker from 1931 to 1955 and by a man who visited her home for a period of years before she became a customer of Mr. Wilder.⁸ She talked to the former about the

⁸The court's opinion adverts to this testimony presumably because it regarded it to be reliable, but apparently not significant in arriving at its decision.

market, interest charges, her portfolio and purchases two or three times a week (R. 4329-4338). He agrees with her that she made up her own mind on security purchases (R. 4335). She educated the latter in the market. She explained to him the difference between commissions paid to a "broker" and "markups" to a "dealer" in over-the-counter transactions, odd lot commissions, "puts and calls", convertible debentures, and trading in commodities. Warrants, debit balances, diversification, interest charges, were part of her ordinary thinking (R. 4216-4227, 4263-67). She told him that trading commodities was for "high rollers", a term, we suspect, commonly employed in gambling houses (R. 4222). Such matters were her main source of interest. Her doctor who appeared to testify in her behalf recalled that she boasted she had made money in commodities unbeknownst to her husband (R. 357).

The Relationship Between Plaintiff and Wilder

Before coming to Harris Upham Mrs. Hecht actively engaged in trading securities and commodities at Hooker & Fay, a brokerage firm of which Wilder was a partner (Exs. 27C-E). She admits she rejected Wilder's recommendation in 1956 to put half her capital into a trust account with a bank so as to preserve her income and her capital,⁹ and maintained at the trial such a trust was a "nuisance" and costly (R. 2894, 2955; Ex. 101 D).

⁹She was married in 1953; her husband died in 1955. It was Mrs. Hecht's first marriage.

Until 1957 Mrs. Hecht made her own records of her trading as she had since the "thirties" (Exs. M, SSS; R. 2523, 2707, 2731, 2847, 2863). Shortly before she came to Harris Upham she employed Wilder to perform these functions and paid him therefor (Ex. H-2; R. 1647, 2390-96). The arrangement and payments continued unbeknownst to Harris Upham and in violation of its rules and the rules of the New York Stock Exchange (R. 727, 733, 1651-2, 3605; Ex. 268). Before and after coming to Harris Upham, but without Harris Upham authority or knowledge, Wilder made up statements from time to time for Mrs. Hecht showing the status of the account (R. 1651-52, 1886) but she denies ever having looked at them or seen them (R. 2480-85, 2942, 2945). She claims no reliance thereon; he merely riffled through the sheets (R. 3035). She states she did not believe what he told her about her account (R. 2958).

Mrs. Hecht spoke to Wilder daily on the telephone (R. 2486, 2719-20) and he would review her activities with her once a week (R. 2396-97). With purchase and sales slips in securities and commodities spread on the table she would ask about them, particularly the reasons for losses (R. 2398, 2704-05). She testified he would refuse her any information, saying she would not understand, and he had to go home for dinner (R. 2398, 2479, 2480-82, 2703-04, 2778-79).¹⁰ She says she would have marked various items in newspapers which suggested investment possibilities

¹⁰The testimony contradicts the court's belief that Wilder "encouraged" her commodity trading. There is no evidence to support the court's inference.

and would turn them over to him, but he would ignore them (R. 2689, 2780; see also R. 2691).

Plaintiff admitted she knew she was losing money for two or three years before the account closed (R. 2704-5) and that she was always aware of the size of the commissions she had been paying—they were a lot (R. 2832-38, 2962-3). In fact, commissions were the subject of conversations between her and Wilder as early as 1957 (*id.*).

Wilder recommended investment in many of the companies whose stock Mrs. Hecht purchased. There is nothing in the record for the conclusion that Wilder recommended the amount of any security purchase or the sale of any security. There is nothing in the record to support a conclusion that all or most of his recommendations were in fact followed. The sole evidence is to the contrary (R. 3576).

Plaintiff stated upon examination by her counsel that from 1956 she had no confidence in and did not trust Wilder (R. 2838, 2925-26, 2958-59, 3028).¹¹ From 1957 she doubted he told the truth about commissions and the status of her account (R. 2838-9, 2958). Her lack of confidence is illustrated by the many claims to which she testified including Wilder's violation of her instructions even before 1957 (R. 2407-08, 2427, 2490-91, 2607, 2705-6); some of these are adverted to

¹¹The court made no finding on the question of trust and confidence, but adverted to her admission. "... however plaintiff may now describe her confidence or lack of confidence in Wilder," (T. 1038). The court's opinion notes that their relationship was also "social" in 1956, but plaintiff insists it was entirely business thereafter (R. 2761, 3025).

in the court's memorandum of decision (see footnote, *infra*).

Plaintiff testified she had no regard for Wilder's opinion of the market (R. 2726-27). From 1957 she was so concerned that her account was not "secure" and "deteriorating" it made her sick (R. 2763-65).

In response to the question why she continued to trade with Mr. Wilder, she testified that Wilder exercised a spell—a magnetic one—over her, and she feared him (R. 2416, 2638, 2929, 2936, 3028-32). She conceded the fear was not physical, and both the spell and the fear seemed to operate only on his weekly visits to her home for five or ten minutes (R. 3017). She did not claim reliance on any fact represented.

The court did not find that Wilder controlled the plaintiff in this extraordinary manner. It assumed, contrary to the fact, that there was some evidence Wilder determined her purchase of securities and commodities. It did not find Wilder encouraged her security trading. It found, without evidence, he encouraged her commodity trading, although her doctors stated she did what she liked, heard what she wanted to hear and then blamed others for her problems (R. 776-79, 328-29).

The Court's Findings With Respect to Plaintiff's Knowledge and "Laches, Waiver and Estoppel"

The court found that even before Mrs. Hecht's account came to Harris Upham she knew and understood she was actively trading securities and speculating in commodities, and knowingly assumed the

risks thereof (T. 1024, 1025, 1026). She knew her instructions to Wilder, if there were such, to handle her security account conservatively, to keep her account in "blue chips", and not to sell certain securities, were being violated (*id.*), and she knew her trading was "unsuitable" and contrary to her "needs and objectives" (T. 1025-1029.)¹²

¹²"Without making distinctions at this point concerning the degree of plaintiff's knowledge of brokerage accounts, we hold and find that her knowledge and experience, together with the information at hand, were at least sufficient to indicate and put her on actual notice that her account was being handled in a manner contrary to her claimed understanding and instructions.

"The confirmation slips and monthly statements, considered in the light of plaintiff's previous knowledge of and experience with brokerage accounts, were sufficient at least to enable plaintiff to see and understand (1) that her account, however, the transfer may have been induced by Wilder, had been in fact transferred from Walston Company to Hooker & Fay and thence to Harris, Upham; (2) that the securities from her husband's estate, however, the deposit may have been induced by Wilder, had been in fact deposited into the brokerage account; (3) that the particular securities, which she now claims were not to be sold, were in fact being sold and repurchased from time to time, and that securities, which she now claims to have been blue chip, dividend-paying securities—and as such to be retained—were in fact being sold and repurchased from time to time; (4) that, whatever may have been her understanding or her instructions to Wilder concerning the manner in which the account was to be handled, it was in fact being handled by Wilder at Hooker & Fay and at Harris, Upham in a manner quite different from the manner of its handling at Walston Company; (5) *that, instead of being maintained intact or substantially so, as a relatively inactive investment type account, as at Walston, it was being very actively traded, not only in the familiar blue chip investment type stocks, but also in a wide variety of stocks being bought and sold from time to time;* (6) *that, however Wilder may have originally gained her consent to enter the commodities markets, she was in fact actively trading in commodities;* and (7) that commissions and interest were being charged to her account in connection with the stock and commodity transactions effected by Wilder. [T. 1024-25]

"We hold, therefore, that *plaintiff must be held to have assumed the ordinary risks of profit or loss in what she knew to be a trading*

The court found “laches, waiver and estoppel”, specifically as those terms are defined by this court in *Royal Air Properties Inc. v. Smith*, 333 F. 2d 568 (1964), and that plaintiff “permitted” Harris Upham to continue handling the account on this basis in reliance upon her apparent acquiescence for nearly seven years.¹³

The court failed to find that plaintiff, as she admitted, knew her profits, losses and commissions (R. 2704-5, 2832-38, 2962-63); but it called attention to the fact that Wilder took her statements away with him each week as evidence of her inadequate opportunity for comprehension. Mrs. Hecht admitted to reviewing her tax returns with her accountant and retaining possession of copies (R. 2424, 2790). These had de-

account in securities and a speculative account in commodities. For this reason the Court considers her contentions (3), (4) and (5) above noted (i.e., that Wilder purchased speculative and low grade securities in place of dividend-paying securities, effected the purchase and sale of commodities without her knowledge or comprehension as to their significance or suitability, and sold securities short (for tax maneuvering purposes) to be unfounded” (T. 1025). (Emphasis supplied).

¹³“Having, with this knowledge and understanding, permitted Wilder and his firm to continue handling the account on this basis in reliance upon her apparent acquiescence for nearly seven years, the Court finds that plaintiff’s conduct is such that she is barred by estoppel, laches and waiver (within the meaning of the second appeal in *Royal Air Properties v. Smith*, 333 F. 2d 568 (1964)) from suddenly taking the position that such trading of the account in securities and commodities was *unsuitable for her needs and objectives, contrary to her instructions and should never have occurred.* [T. 1025]

“In any event, we have found on the evidence in this case that plaintiff is barred by estoppel and waiver from proceeding merely upon the theory that her account, as handled by defendants, was ‘unsuitable’ to her needs and objectives.” (T. 1028-29) (Emphasis supplied).

tailed schedules of purchases, sales and commissions which she understood (Exs. H14-H17; R. 1850, 2847-2852, 2861-62, 2873). Her records were kept by Wilder at her request as her paid employee unbeknownst to Harris Upham, and she could have terminated his employment at will. Her monthly statements, sent from New York on the last Friday of the month, were in her possession until Thursday when Wilder generally called (R. 738, 2396, 2756). Wilder furnished her from time to time with the market prices of all her holdings (Exs. 20F-3-20F-13).

The court also failed to find, as Mrs. Hecht admitted, that she distrusted and had no confidence in Wilder and had no regard for his market judgment or veracity (R. 2838-9, 2958), that she felt from 1957 that her account was not safe and it made her sick (R. 2764).

The court found that Mrs. Hecht did not "comprehend" the risk of "churning". It did not define that risk.

The court held that Wilder should have warned plaintiff in 1963 against "churning" securities because of the depletion of her account. It failed to recognize her account had long since ceased to be active (Exs. 293, 324, 325, S-9).

The court stated Wilder's analysis of Mrs. Hecht's security account in March 1963 was inaccurate and that Wilder admitted discussing it with her. It failed to note that (1) Mrs. Hecht denied seeing any statements (R. 2480-85, 2942-45), (2) she testified she disbelieved his representations as to her account (R.

2958) and (3) she knew she was losing money for two or three years (R. 2704-05). The court did not and could not find reliance. Nor does this or any other analysis of Wilder deal with the extent of trading.

Plaintiff's Security Trading

Plaintiff had an active securities account with Harris Upham from May 1957 through 1961. She profited (S-5, S-11), and her net worth substantially increased despite withdrawals and losses in and transfer to commodities (R. 3302; Exs. 285, 289, 291). It was in 1962 that plaintiff's account deteriorated with a sharp market drop (S-1).¹⁴ Whether measured by the statistics of plaintiff or defendant, plaintiff's account was inactive from 1962 through 1964, even by the standard of an investment account. It was turned over at a rate of approximately once every twenty-two months (Exs. S-9, 293, 324, 325).

Plaintiff's portfolio was turned over approximately seven times in seven years (Exs. 324, 325).¹⁵ Her capital turnover was higher (Ex. 293).¹⁶ Neither would appear to be remarkable for a trading account which the court found Mrs. Hecht had knowingly chosen to operate—seemingly without Wilder's encouragement. Neither would be indicative of "churning" in an investment account.

¹⁴The drop affected "blue chips" (R. 1953).

¹⁵Weighted average. The court's figure of eight times is unweighted.

¹⁶In a margin account the percentage turnover of capital is necessarily higher than the portfolio turnover. Margin is not uncommon in a trading account.

The record does not disclose the market trend of any security or the activity in the market for a security in particular, or generally at any given time during the period in issue. There is no evidence and no finding that any purchase or sale made by plaintiff was not justified in a trading account (or investment account) by the exigencies of the market. There is no evidence that the amount of plaintiff's commissions was extraordinary or even large for a trading account in securities. Only one witness purported to testify on this subject. He was an investment adviser and testified that such commissions were large in terms of an investment account which he considered plaintiff should have had, rather than as a trading account (R. 1955). He claimed no experience in trading accounts (R. 2189-2191) and expressed strong disapproval of modern "performance funds" which look to turnover and capital gains (R. 1942, 1943).

The court recited statistics to show Wilder's special interest in the account. The statistics combined commissions in commodities with securities, and ignored the fact neither the record, nor common knowledge of which it could take judicial notice, furnished standards by which to evaluate these commissions, especially commodity commissions, to determine that Wilder disregarded plaintiff's interests.

The court did not find that Mrs. Hecht's trading was "excessive" as a trading account. Presumably it was excessive for her situation, needs and objectives,¹⁷

¹⁷"Churning cannot be and need not be, established by any one precise rule or formula. The essential question of fact for determination is whether the volume and frequency of transactions,

facts it found she knew in 1957. The court did not find Mrs. Hecht was unaware of Wilder's motive. Mrs. Hecht insists she did not trust Wilder.

Plaintiff's Commodity Trading

Contrary to the findings of the court, Mrs. Hecht did not engage in 9,000 commodity "transactions."¹⁸ Plaintiff's proof, and the stipulation of the parties, is that she engaged in approximately 700 "transactions" (R. 1426, Ex. 292). She did not buy and sell \$89,000,000 or \$90,000,000 of commodities. She never bought commodities; she bought "future contracts"¹⁹ (R. 1492-94, 1749-50; court statement R. 3349), 99% of which do not ordinarily mature into deliveries (R. 1840). There is no evidence that her commodities account was excessively traded. A "turnover" of 2,500 times found by the court, or any other number of times, is not meaningful or significant because the amount of funds held in a commodity account is only the amount required by the exchange regulation. The sole witness who testified that commissions were large was the same security investment adviser. He confessed to knowing nothing about commodities; commodities were a "curiosity" to him (R. 2189, 2202).

considered in the light of the nature of the account and the situation, needs and objectives of the customer, have been so 'excessive' as to indicate a purpose of the broker to derive profit for himself while disregarding the interests of the customer. E.g., *Looper and Company*, 38 SEC 291 (1958)." (T. 1038).

¹⁸There is nothing in the record to support this figure or from which it could be deduced.

¹⁹A single commission is paid on purchase and sale (R. 1740, Exs. 22C, 22G, et seq.).

The evidence with respect to commodity trading given by plaintiff's expert was: It would be necessary to examine plaintiff's trades in relationship to the market activity in a particular commodity in order to make a determination of churning (R. 1818, 1824, 1825). [No such market data was offered in evidence (R. 1825).] Daily turnover would not necessarily be churning in an active market (R. 1826). In the commodities market it is important to close out most positions promptly. "You cut your losses short and let your profits run" (R. 1842). He also testified, if such testimony were not obvious, that the objectives of customers in the commodities market was making money and not investment (R. 1824). Indeed, it is impossible to "invest" in the commodities market because all commodity options are relatively short term.

If the term "churning" has any significance in commodities, it surely was not indicated or proved. The "needs and objectives" of the customer, as employed in the court's opinion, are according to plaintiff's expert foreign to the context of such trading (R. 1823, 1824). Furthermore all commodity trading leads to a "high turnover", thus rendering the concept totally meaningless. For example: \$500 may well finance the purchase and sale of a future contract for \$10,000 of a commodity—or a turnover by the court's method of counting of forty times! Closing a position in thirty days might well (according to plaintiff's expert) be too slow and increase risk, depending on market conditions. But such turnover annualized produces a 480 "times turnover". It is very doubtful that

the court intended to find “excessive turnover” of commodities; the opinion is not clear as to what it regarded churning of commodities to be.

Obviously, the court did not grasp the facts or the theory of churning when it found commodity “churning”.²⁰ Its concern with plaintiff’s “excessive” commodity trading was the product of misapprehension and clearly erroneous. This misapprehension was the basis of its finding of security churning, for as we have noted the court added commodity and security trades and commissions in making this finding. The finding of security churning was therefore clearly erroneous for this among other reasons.²¹

Defendants’ Supervision

The record contains a precise description of defendant’s internal supervision to assure the Securities Exchange Act is not violated (R. 713 et seq., 728-37, 740). The court neither found nor rejected such testimony. It held Harris Upham liable because its resident partner failed to meet Mrs. Hecht, on the theory that a brokerage firm must “know” its custo-

²⁰“ . . . and that, whatever she may have been told by others about the risks of the commodities market, plaintiff relied on Wilder as to whether this remarkable entry of a relatively unsophisticated widow into the badlands of the commodity market, followed by nearly seven years of intensive and continuous commodity trading, was excessive when considered in light of the nature of her account, her situation and her needs and objectives.” (T. 1038)

²¹“The evidence in the pending case is such that the Court is satisfied that, judged by the foregoing considerations, plaintiff’s account, even considered as a trading security and commodity account, was grossly and unfairly churned by Wilder for no reason other than to generate profits for the firm and indirectly for himself.” (T. 1039)

mers. Wilder knew his customer, and no rule requires a partner to "know" her (Ex. 268, Rule 405). Her account from the very first was marked as a "trading" account.

Meeting Mrs. Hecht would have accomplished nothing. She admits she hid her problems and illnesses from Wilder (R. 2503, 2761-62, 3762-63).

Supervisory "rules" intended to prevent violation of the Securities Exchange Act, are not necessarily applicable to commodity trading. They were presumably incorporated by the court below.

Findings by the Court on Evidence Not Admitted Against Defendant Harris Upham, and "Itek" and "Colonial"

1. Matters Predating May 1, 1957:

At the trial the court excluded against Harris Upham all matters preceding May 1, 1957 (R. 2313-15, 2390-91). It found against Harris Upham that Wilder "induced" Mrs. Hecht to engage in commodities in 1956.²² This finding is of the essence to establish Wilder's impropriety and liability under Rule 10b-5. Moreover, if Mrs. Hecht was not "in-

²²"As far as commodity transactions are concerned, this Court, considering the evidence as a whole, finds that the plaintiff's letter of June, 1956, concerning 'starting me on soy beans when you think it is the right time' was in fact written upon the encouragement and recommendation of Wilder, the commodities specialist . . . (T. 1037-8)

"In any event, we hold that, where a registered representative, handling a securities account induces a customer to open a commodities account to provide an additional opportunity for generating commissions, the commodity account may be regarded as a mere device for churning the securities account and any commissions derived from excessive commodity trading may be regarded as in effect a churning of the securities account." (T. 1043)

duced", then surely she cannot complain. It is also germane to the court's conclusion that Wilder's interest in commissions exceeded his regard for Mrs. Hecht's best interests, which the court seemed to regard as the main, if not the sole element of churning (see *supra*).

2. Itek and Colonial:

As the court's opinion recites, Mrs. Hecht purchased some shares of Itek in 1958 which were delivered to her under her instructions. These securities registered in her name were delivered to her by Harris Upham—not by Wilder (R. 1454, 3446, 3458). Some months later Wilder bought these securities from her privately on his own behalf, not on behalf of Harris Upham (R. 3445, 3447, 3606-07). Mrs. Hecht did not testify and nothing in the record suggests that Mrs. Hecht believed that such securities were bought from her by Harris Upham. The check delivered by Mr. Wilder was not a Harris Upham check (see Ex. 304; R. 3445-3447, 3458, 3471). The stock was subsequently sold by the Bank of California for Mrs. Wilder (R. 3505). The court's criticism of the transaction is that between the time of purchase and the time Wilder received delivery, these securities had gone up in value, and Wilder profited unbeknownst to Mrs. Hecht.

The Colonial transaction consisted of private purchases and gifts made of securities by Mrs. Hecht to Mrs. Wilder. These purchases were not made through Harris Upham (R. 3480), or in any market or exchange. Neither the securities purchased or any other

aspect of these transactions went through the records of Harris Upham (R. 3505), nor is it suggested Harris Upham had any knowledge thereof or profited thereby.

Plaintiff testified she "suddenly remembered" the transaction (R. 3590-91), yet the court found that Mrs. Hecht did not know what she was doing.

Neither the Itek nor the Colonial transaction was pleaded; neither was admitted against Harris Upham during the trial (R. 3459-3460, 3468, 3482, 3502, 3509-13, 3526, 3586, 3591). The testimony with respect to both of them was first offered in June 1967, and admitted over Statute of Limitations objection in March of 1968 (R. 4745-4748), more than three years after the plaintiff's discovery of the facts in issue, as she alleged in her complaint (par. 17). The documentary and other proof is that Wilder had no authority to engage in any private business with Mrs. Hecht (Ex. A; R. 3601-7).

The court found Harris Upham liable under Section 20(a) and common law agency.

Mrs. Hecht's Profits and Losses

Mrs. Hecht made \$165,000 in trading securities (Ex. S-5) despite a sharp drop in the security market in 1962 (Ex. S-1). Many of the securities held or purchased in 1962 increased in value in 1963 and early in 1964 (Exs. S-3, S-3a). Plaintiff's expert witness on "investments" testified to a sharp drop in "blue chips" in 1962 (R. 1963); many of Mrs. Hecht's unliquidated losses in March 1964 were in these "blue

chips" which had not been traded (R. 1910 et seq., 1947-1950).

The Losses in Commodity Trading

Mrs. Hecht's commodities account did not result in substantial profit or loss during the years 1957 through 1962 (Ex. 292). In 1963 the commodities market in soy bean and oil reacted sharply to the DeAngelis scandal (R. 1827-32). DeAngelis had put many forged warehouse receipts into the market. When the forgeries were discovered, the result was so catastrophic that major banks on both coasts, business organizations and brokerage houses suffered serious losses (id.). Plaintiff's expert recalled the facts and testified that for many months the market was unbalanced because government statistics became unreliable (id.). Mrs. Hecht's losses resulted from this event. It is really the basis for all her claims (R. 1180, 3364, 3365; Ex. 279).

Commingleing of Assets

Accountants for both plaintiff and defendant had no difficulty in reviewing Mrs. Hecht's monthly statements from Harris Upham and determining the amounts of money which went into and out of her commodities account. Such transfers were made with her authority (Exs. 95, 96). There was no more commingling of her securities and commodities accounts than there is in an ordinary bank statement account which shows deposits and withdrawals and transfers from checking account to savings account. Harris Upham's monthly statements (like all other brokers')

show such transfers (Exs. 21 and 22). A brokerage house must keep the cash balance in commodities accounts at a minimum when a customer has a securities margin account, to avoid an interest overcharge. Its records are kept as accurately as a bank, and are subject to annual "surprise audits" pursuant to Stock Exchange direction.

Damages

1. Security and Commodity Commissions:

The court awarded all security and commodity commissions and \$15,000 unproved commissions.²³ It awarded the commissions paid during periods when the security account was inactive. It did not allocate commissions fairly earned from those resulting from "excessive trading". It did not allocate commissions earned to which plaintiff had acceded or which she was barred from claiming by her laches, waiver and estoppel. It did not allocate, even when the allocation could be precisely computed, e.g., security commissions during 1962-1964 when the account was inactive or commodity commissions in 1957 when the commodity account was very modestly traded (Ex. 292).

2. Interest Charges:

The court awarded all of the interest charges paid by plaintiff on her margin account although it charged her with knowledge of them. The defendant's "profit" on interest charges paid by the plaintiff was

²³Total security commissions were \$76,000, not \$91,000 (Ex. 283, court opinion, T. 1021).

1½%, for defendant borrows money and marks up its interest in that amount (R. 711). The court made no allowance for the gains, interest and dividends earned by the loans extended to plaintiff.

3. Losses in Commodities:

The court found plaintiff assumed the risk of loss in commodity trading (see footnote 12), but it awarded plaintiff losses from commodity trading. There was no evidence that these losses were due to excessive trading. The evidence is to the contrary (see *supra*).

4. The Loss in Income Due to Trading Commodities:

The court awarded \$65,000 as income lost because \$245,000 went into the commodities account over seven years. The court found that the account on average had \$35,000 (T. 1040). It did not consider the amount earned by the moneys transferred back from the commodities account to the securities account (R. 2248). It did not make any finding or explain how the amount of \$65,000 was reached. It made no finding that Mrs. Hecht was unaware or did not comprehend she was using funds to trade commodities. Her testimony is to the contrary (R. 2404-2405).

5. Interest:

Interest was awarded on moneys paid for margin and commissions, as if these awards were compensatory rather than penal.

SUMMARY OF ARGUMENT

The position of Harris Upham with respect to most of the issues is sufficiently apparent from the statement of facts; we do not believe a summary would assist the Court. The overall aspects are herewith stated.

The court below found that Mrs. Hecht knew and understood, even before she came to Harris Upham, that Wilder was managing her account contrary to her claimed instructions, her understanding of her best interests and in a manner “‘unsuitable’ to her needs and objectives”, and that she “permitted Wilder and his firm to continue handling the account on this basis.” It alluded to Mrs. Hecht’s admission that she distrusted and had no confidence in Wilder or in his judgment, but deemed it irrelevant. It acknowledged the decisions of this Circuit and other circuits limiting Section 10(b) of the Securities Exchange Act to misrepresentation, non-disclosure and a person misled, and the decisions of this Circuit making the defense of laches, waiver and estoppel applicable to Mrs. Hecht’s claims. But it held “. . . this case cannot be and will not be resolved on the simplistic formula on which either side ‘can take all’.”

The court thereupon swept aside the mandate of the statute, the decisions of this Circuit and other circuits and of the Supreme Court. It ignored the fact that Mrs. Hecht’s acquiescence, consent and participation in her trading activities with knowledge and understanding made the Securities Exchange Act inapplicable. It did not interpret the law as a trust

statute, for a beneficiary cannot charge a trustee with acts she approved or in which she acquiesced, as plaintiff did. It did not transmute the duties of a broker to those of an investment adviser for he is only called upon to advise. It assumed unlimited jurisdiction to determine the "equities", and extended the Securities Exchange Act to hold a broker liable for activities of which it or a jury might disapprove because they were contrary to plaintiff's needs without regard to non-disclosure, material misrepresentation, reliance, proximate cause, acquiescence, consent or participation.

The court applied Rule 10b-5 to all manner of broker-customer relationships. Commodity trading was brought within the provisions of the Securities Exchange Act. Seemingly it held that Mrs. Hecht's commodity and security trading accounts, perhaps as a single activity, were excessively traded and that such trading, labeled "churning", was alone sufficient to violate 10b-5. It failed to state clearly its standards in determining such excess; it did not hold they were excessively traded by the standard of active trading accounts to which Mrs. Hecht had acceded. It found excessive trading without the benefit of expertise and contrary to the testimony of plaintiff's experts. It found "churning" without finding non-disclosure, misrepresentation (material or otherwise), reliance or loss proximately caused thereby.

On the basis of its findings of plaintiff's knowledge and understanding recited above, the court held the defenses of laches, waiver and estoppel to be appli-

cable. But it failed to recognize that a plaintiff, suspicious and distrusting and aware that her account was being subjected to excessive risk by the very activities the court found culpable, was charged with the further knowledge or understanding inquiry would have disclosed, and surely with the need to discontinue any further dealings with Wilder except at her own risk, that she could not wait "to see how [her] investment turns out before decid[ing] to invoke the provisions of the Act" (*Royal Air Properties Inc. v. Smith*, 312 F. 2d 210, 213, 224 (9 Cir. 1962)). Similarly, it regarded the applicable Statute of Limitations tolled by non-disclosure, but failed to find non-disclosure of fact, and ignored, as it did with regard to laches, waiver and estoppel, that plaintiff was charged with the knowledge she had and that which she should be expected to obtain.

In its judgment the court did not limit damages, because of laches, waiver and estoppel, to matters Mrs. Hecht did not know or understand. It returned to the plaintiff all the commissions and interest it agreed she knowingly expended, even commissions for profitable trading. It granted to her damages for losses resulting from risk it found she knowingly assumed, and for loss of income she contemplated and realized. It did not find—nor did it appear to consider such a finding relevant—that such damages were proximately caused by defendant's breach of duty; nor did it consider they were barred by the fact that she "permitted Wilder and his firm to continue handling" her account in the precise manner it was for seven years.

ARGUMENT

POINT I

THE COURT WAS WITHOUT JURISDICTION

Complaints parallel to the one before this Court have been uniformly dismissed.

Colonial Realty Corporation v. Bache & Co.,
358 F. 2d 178 (2 Cir. 1966) ;

Barnett v. Anaconda Company, 238 F. Supp.
766 (S.D.N.Y. 1965) ;

Meisel v. North Jersey Trust Co., 218 F. Supp.
274 (S.D.N.Y. 1963) ;

Seward v. Hammond, 8 F.R.D. 457 (D. Mass.
1948) ;

Cooper v. North Jersey Trust Co., 226 F. Supp.
972 (S.D.N.Y. 1964) ;

Rosen v. Bergman, 40 F.R.D. 19 (S.D.N.Y.
1966).

See opinion of Sweigert, J., *C.M.C. Corp. v. Kern County Land Co.*, CCH Fed. Sec. L. Rep. ¶92275 (N.D. Cal. 1968).

A. The Issue of Jurisdiction Was Properly Raised.

The court below was required under Rule 12(h) of the Federal Rules of Civil Procedure and by a host of cases to consider at pretrial a motion to dismiss on the ground of lack of jurisdiction. It could not decline to consider its jurisdiction.

United Mine Workers v. Gibbs, 383 U.S. 715 (1966).

In matters where the facts are as complex as violations of the Security Acts tend to be, or the complaint ambiguous, the motion is preferably brought

at pretrial as it was here, rather than at the pleading stage.

A. T. Brod & Co. v. Perlow, 375 F. 2d 393 (2 Cir. 1967);

Berger v. Brannan, 172 F. 2d 241 (10 Cir. 1949) cert. den. 337 U.S. 941.

If the pleadings against Harris Upham, as distinguished from the pleadings against Wilder, failed to state a cause of action federally cognizable the action against it must be dismissed even on appeal.

Gully v. First National Bank, 299 U.S. 109, 115 (1936);

United Mine Workers v. Gibbs, 383 U.S. 715 (1966).

B. Mere Allegation of the Federal Statute, or Even Facts Indicating a Violation of Federal Statute, Is Not Enough to Invoke Federal Jurisdiction.

The federal violation must be the proximate cause of the damage sought.

Gully v. First National Bank, 383 U.S. 715 (1966);

Lapchack v. Sisto, OCH Fed. Sec. L. Rep. ¶ 90721 (S.D.N.Y. 1955);

Hoover v. Allen, 241 F. Supp. 760 (S.D.N.Y. 1965).

The allegations of federal violation may not be incidental to the relief or merely duplicate in part a state law cause as it does in the complaint and pretrial statement; it must be the essential claim and the basis for the relief sought.

Gully v. First National Bank, 383 U.S. 715 (1966);

Barnett v. Anaconda Company, 238 F. Supp. 766 (S.D.N.Y. 1965);

Meisel v. North Jersey Trust Co., 218 F. Supp. 274 (S.D.N.Y. 1963).

C. No Claim Was Asserted Against Harris Upham.

The pretrial statement failed to state common law or statutory grounds for making Harris Upham a party. No facts were alleged to charge it with knowledge of entrustment, bad faith or participation under Section 20(a).

Kamen & Co. v. Paul H. Aschkar & Co., 382 F. 2d 689 (9 Cir. 1967), cert. granted, 88 S. Ct. 1021 (1968).

D. Breaches of Trust, Contract or Fair Trade Practices Are Not a Violation of Federal Law.

Plaintiff's action and her damages were for breach of trust and breach of contract. These are not violations of federal law.

Los Angeles Trust D. & Mtg. Exchange v. Securities and Exchange Commission, 264 F. 2d 199, 210 (9 Cir. 1959);

Glickman v. Schweickart & Co., 242 F. Supp. 670 (S.D.N.Y. 1965);

Seward v. Hammond, 8 F.R.D. 457 (D. Mass. 1948);

Meisel v. North Jersey Trust Co., 218 F. Supp. 274 (S.D.N.Y. 1963);

Cooper v. North Jersey Trust Co., 226 F. Supp. 972 (S.D.N.Y. 1964);

Keers and Company v. American Steel Pump Corp., 234 F. Supp. 201 (S.D.N.Y. 1964).

Nor are unfair trade practices.

Colonial Realty Corporation v. Bache & Co., 358 F. 2d 178 (2 Cir. 1966).

Material misrepresentation, or non-disclosure, reliance and proximate cause need to be recited, certainly in a pretrial memorandum, to come within Rule 10b-5.

Royal Air Properties, Inc. v. Smith, 312 F. 2d 210 (9 Cir. 1962);

Los Angeles Trust D & Mtg. Exchange v. Securities and Exchange Commission, 264 F. 2d 199, 209 (9 Cir. 1959);

Smith v. Bear, 237 F. 2d 79, 88 (2 Cir. 1956);

Matheson v. Armbrust, 284 F. 2d 670 (9 Cir. 1960), cert. den. 365 U.S. 870;

Fischman v. Raytheon Mfg. Co., 188 F. 2d 783 (2 Cir. 1951);

List v. Fashion Park, Inc., 340 F. 2d 457 (2 Cir. 1965), cert. den. 382 U.S. 811;

Baird v. Franklin, 141 F. 2d 238 (2 Cir. 1944);

C.M.C. Corp. v. Kern County Land Co., CCH Fed. Sec. L. Rep. ¶ 92275 (N.D.Cal. 1968).

While a "trust" or "fiduciary" relationship may increase the need for disclosure of facts unknown and not apparent, they do not obviate the need for proving fraud by non-disclosure as distinguished from other breaches of trust.

Charles Hughes & Co. v. SEC, 139 F. 2d 434, 437 (2 Cir. 1943), cert. den. 321 U.S. 786.

The assumption of jurisdiction by the federal courts merely because a federal statute is cited, or "fraud" is employed to label defendant's conduct would deprive state courts of their traditional jurisdiction in actions in which securities are in any respect involved. Section 27 of the Securities Exchange Act provides that federal courts "shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits . . ." It would also eliminate the right of either party to seek arbitration provided by the security exchanges. See *Colonial Realty Corp. v. Bache*, supra (at pp. 182, 183), for a detailed analysis of this issue.

We submit the court should be chary of permitting invocation of federal jurisdiction, just as the Second Circuit has been. The result is not a harsh one; counsel for the plaintiff was fully familiar with the limitations of a federal right of action; he had appeared as counsel for a defendant in *Meisel v. North Jersey Trust Co.*, supra, and had successfully raised this issue.

E. "Excessive Trading" Alone Does Not Create a Federal Right Under Section 10(b) and Rule 10 b-5 of the Securities Exchange Act.

"Excessive trading" was only incidentally alleged in the complaint and inadequately supported at pre-trial. It would not be sufficient to sustain federal jurisdiction. But since the court's opinion relies exclusively on "churning" to grant damages, some not

even contemplated by the pleader, we set forth the statutory background to demonstrate that an allegation of "excessive trading" alone is not a violation of Rule 10b-5.

The only statutory or regulatory reference to excessive trading appears in Rule 15c 1-7 of the Securities and Exchange Commission under Section 15c-1 of the Securities Exchange Act. Section 15 legislates only with respect to over-the-counter securities.

It is doubtful that Rule 15c 1-7 describes a deceptive or fraudulent device. 3 Loss, *Securities Regulation*, p. 1481 (1962). But we do not need to discuss this issue. A complaint based on violation of this section alone would be barred by the one-year statute of limitations in Section 29(b) of the Act.

Goldenberg v. Bache & Co., 270 F. 2d 675 (5 Cir., 1959);

Maher v. J. R. Williston & Bean, Inc., 280 F. Supp. 133 (S.D.N.Y. 1967).

Section 10(b) of the Securities Exchange Act does not prohibit any conduct except that proscribed by the Commission. Rule 10b-3 incorporates the definition of "'manipulative, deceptive or other fraudulent device' as such term is used in section 15(c)(1) of the Act"; but transactions over a national securities exchange are excluded. The reason for the exclusion is apparent. The vice of excessive trading is the cost, which is often hidden and is generally higher in over-the-counter transactions, but is obvious in national exchange transactions, perhaps not to the novice, but surely to someone who has traded for any period.

In any event "excessive trading" is not *per se* a violation of Rule 10b-5.

Excessive trading might conceivably be part of a course of conduct or a device, scheme or artifice which would operate as a fraud, and would therefore be prohibited by Rule 10b-5. But facts leading to the conclusion that plaintiff was defrauded or misled by her reliance to her damage by defendants' course of conduct, material non-disclosure, misrepresentation, or deceptive device, are not set forth in the pleadings, nor are such facts stated in the pretrial statement, as they needed to be to invoke Rule 10b-5.

Plaintiff could not so allege because her entire theory of action as pleaded is that she turned over her assets to Wilder in 1955 before she came to Harris Upham and was told nothing by him throughout the time she was a customer of Harris Upham. She was completely detached from the activities of her account.

POINT II

PLAINTIFF'S COMMODITIES TRADING DOES NOT COME WITHIN THE JURISDICTION OF THE FEDERAL COURTS

A. Commodities Are Not Securities and the Court Lacked Original or Pendant Jurisdiction.

Commodities are not securities, and impropriety, if any, in commodity trading does not come within the Security Acts. See:

Sinva v. Merrill Lynch, Pierce, Fenner & Smith, 253 F. Supp. 359 (S.D.N.Y. 1966),
and cases there cited.

Jurisdiction over commodity transactions can be predicated, if at all, only upon pendant jurisdiction, whose limitations the court below refused to consider at pretrial, as it was required to do.

United Mine Workers v. Gibbs, 383 U.S. 715 (1966).

To determine the scope of pendant jurisdiction, it is necessary to define the scope of primary jurisdiction. Since a breach of trust with respect to a securities account is not the basis of original jurisdiction, such a claim cannot bring within the federal courts a breach of trust with respect to commodities, the precise claim in plaintiff's complaint.

Assuming *arguendo* that plaintiff pleaded a cause of action cognizable in federal law of excessive trading of securities, it would not follow that the court would have pendant jurisdiction over a parallel course of conduct in connection with the trading of commodities even if it had been pleaded. *United Mine Workers v. Gibbs*, *supra*, defines the scope of federal pendant jurisdiction as a "common nucleus of operative facts". See also:

Moynihan v. Pari-Mutuel Employees Guild, 317 F. 2d 209, 211, 212 (9 Cir. 1963), cert. den. 375 U.S. 911;

Fidelity Deposit Co. of Md. v. Harris, 360 F. 2d 402, 441 (9 Cir. 1966);

Dubil v. Rayford Camp & Co., 184 F. 2d 899 (9 Cir. 1950).

The essence of "churning" of securities is discretionary "purchases and sales which are excessive in

size and frequency in view of the financial resources and character of the account" (Rule 15c 1-7) and fraud. Proof of excessive trading of securities is completely different from proof of excessive trading of commodities. The transactions and facts to be proved are different and separate, the standards by which excessive trading is measured are different because the markets are totally different. The broker is under no obligation to see to his client's "needs", "circumstances" or "objectives". All who enter the market come to speculate.²⁴ The two areas do not share a "common nucleus of operative facts", only a common adjective.

The court below sought to encompass commodity trading into security trading by finding a nexus between them instead of a common nucleus of operative facts. That nexus was alleged commingling. Aside from the fact that no commingling existed or was pleaded, the nexus would not suffice. The theory of the court below would automatically grant federal jurisdiction to every plaintiff customer who had both a securities and commodities account with the same broker and complained about both. Surely such breadth of jurisdiction was not contemplated by Congress.

Errion v. Connell, 236 F. 2d 447 (9 Cir. 1956), *Sinva Inc. v. Merrill Lynch, Pierce, Fenner & Smith*, supra, and *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967) (cited by the court) are not to the contrary. A single transaction involving secu-

²⁴Except warehousemen, producers and consumers who hedge.

rities and commodities may come within the Security Acts and appropriate allegation may escape a motion to dismiss a pleading. But a broker's commodity trading cannot be searched under the Security Acts because his security trading is so searched.

B. The Court Below Erred in Incorporating Commodity Trading Into Rule 10b-5.

Because it lacked pendant jurisdiction the court sought to invoke federal jurisdiction by describing the trading in commodities as the means of making commissions in securities trading. Even poetic license would not admit of such a description. Selling real estate, watches and toys are also means of making commissions. A broker's suggestions to a customer for trading commodities is surely a method of making commissions, but it is making commissions in commodities, not in securities, and is not the regulation Congress intended. Furthermore, earning commissions is not a federally prohibited act, and is not a legally operative fact which would be the basis for a common nucleus.

Implicit in the court's analysis and judgment is that there are two laws applicable to commodity trading: One that applies when there is a security account, and one that applies in the absence of a security account. Presumably, if Mrs. Hecht had her security account elsewhere she would not be entitled to relief for her commodity trading, even if the court had jurisdiction. Or was the court of the view that "churning" beans is subject to Securities and Exchange Commission regulation?

C. Federal Law Does Not Prohibit "Excessive Trading" of Commodities.

Congress has provided for the regulation of certain commodities exchanges by the Department of Agriculture, not by the Securities and Exchange Commission (Commodity Exchange Act, 7 U.S.C. §§ 1-17a). The Securities and Exchange Commission, therefore, could not have issued any rule or regulation under Section 10(b) with respect to commodities. Nor does the Securities and Exchange Commission attempt or intend to regulate improper conduct or fraudulent or manipulative device in the trading of commodities. Furthermore, irrespective of the propriety or impropriety of the plaintiff's trading of commodities with defendant, excessive trading of commodities is not a tort under any law, absent fraud or deceit which plaintiff failed to claim or prove, and the court failed to find²⁵ (7 U.S.C. § 6b).

POINT III

**PLAINTIFF'S CLAIMS ARE BARRED BY HER
LACHES, WAIVER AND ESTOPPEL**

In *Royal Air Properties Inc. v. Smith*, supra, this court held:

"The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act." (312 F. 2d at 213-14.)

²⁵More than a violation of Section 20(a) would be needed to bind Harris Upham.

It held doctrines of estoppel, waiver and laches may be invoked against a plaintiff claiming under the Security Acts. It cited:

Carr v. Warner, 137 F. Supp. 611 (D. Mass. 1955);

Nash v. Warner, 137 F. Supp. 615 (D. Mass. 1955).

In both *Warner* cases plaintiff claimed churning of securities accounts. In both of them the same allegations were made by the plaintiff as are made by Mrs. Hecht, and the same proof tendered. The claims were rejected. Neither of the plaintiffs had the experience that Mrs. Hecht had in the trading of securities. Neither had assumed the risk of a "speculative" commodity account as the court found Mrs. Hecht had. Neither of them admitted studying their brokerage accounts on a day to day basis, or talking to their broker daily. Both of them asserted their confidence in and reliance on their registered representatives, and Mrs. Carr regarded her broker a family friend.

Unlike the court below, the court accepted their testimony as reliable. But it charged them with an ability to read and understand the slips they received which showed their commissions, just as the court in the instant case found that Mrs. Hecht could read her slips. It was not swayed by "comprehension of risk", as the court below was, for that does not suggest non-disclosure, and the "risk" of paying commissions is apparent.

See also:

Merrill Lynch, Pierce, Fenner & Smith Inc. v. Bockock, 247 F. Supp. 373 (S.D. Tex. 1965).

The court below accepted the mandate of this court in *Royal Air Properties Inc. v. Smith*, supra. It held that plaintiff was barred by estoppel, laches and waiver specifically as those terms were defined in *Royal Air Properties Inc. v. Smith*, 333 F. 2d 568, 571 (9th Cir. 1964), and found all the facts required. But it found extensive damage because plaintiff's knowledge was insufficient to appreciate the "risk". The court did not define the risk or state how it differed in character from that of actively trading securities and speculating in commodities to which plaintiff agreed, although she knew it was contrary to her wishes and her needs. There is no risk. Risk is a function of the quality of the securities held, not of turnover. Excessive trading leads to excessive commissions, not to risk, a fact of which plaintiff surely was aware since 1931, and had again impressed upon her when she began actively to trade at Hooker & Fay in 1955 and 1956. Actually, plaintiff evaluated her situation with Wilder as "insecure" in 1957. Failure to appreciate the importance of commissions is a beginner's error. For plaintiff to have appreciated the risk of buying non "blue chips", as the court found and plaintiff testified, and yet not comprehend the cost of trading after twenty-five or thirty years of market interest beggars understanding, especially since there was no testimony to support the finding, and Mrs. Hecht assured the court she knew her commissions were a lot and "accumulating". Surely persons aged 65 cannot be presumed to have lost such elementary understanding and judgment. The presumption if any would be contrary.

The court below failed to recognize that the doctrine of laches and estoppel applies not only to what the plaintiff specifically knew but also to what she had reason to know. In the second *Royal Air Properties* case, this court stated:

“To hold one to diligence in discovering his rights is reasonable in the case of laches and estoppel, where another has acted in the interim to his detriment. The defenses of laches and estoppel do not spring principally from intent, as does waiver, but from injury to the deceived party caused by neglect or misleading action to the delaying party. But no detriment to a third party is required for waiver, it is unilaterally accomplished.” 333 F. 2d at 571.

Cf. Turner v. Lundquist, 377 F.2d 44 (9 Cir. 1967).

The imputation of knowledge, particularly in matters involving fraud, to what a plaintiff, judged by the standards of a reasonable man, should have learned by investigation is set forth in detail in *Davidson v. Grady*, 105 F.2d 405, 408 (5 Cir. 1939). The court, speaking through Hutcheson, J., stated:

“... there is knowledge or notice of a fraud if there is reasonable opportunity to acquire knowledge, *Wetzel v. Minnesota*, 169 U.S. 237, 18 S.Ct. 307, 42 L.Ed. 730. One, in short, will be charged with knowledge, where the evidence leads to the conclusion that he could have informed himself of the facts by the degree of diligence which the law required, *Charles Foster v. Mansfield, Coldwater & Lake Michigan Railroad Co.*, 146 U.S. 88, 13 S.Ct. 28, 36 L. Ed. 899, where the circum-

stances of which he was cognizant were such as to put a man of ordinary prudence on inquiry.”

Directly in point is *Holman v. Gulf Refining Co.*, 76 F.2d 94, 99 (5 Cir. 1935) where the plaintiffs conceded, as plaintiff here does, their discontent and suspicions:

“While ordinarily none exists as to unsuspected fraud, particularly touching a confidential relationship, yet where there is suspicion neglect to learn what might be known is counted as knowledge. *Foster v. Mansfield*, etc., 146 U.S. 88, 89, 99, 13 S.Ct. 28, 36 L. Ed. 899; *Johnston v. Standard Mining Co.*, 148 U.S. 360, 13 S.Ct. 585, 37 L. Ed. 480; *Broderick’s Will*, 21 Wall. 503, 504, 22 L. Ed. 599; *Burke v. Smith*, 16 Wall. 390, 391, 401, 21 L. Ed. 361; *Felix v. Patrick*, 145 U.S. 317, 12 S.Ct. 862, 36 L. Ed. 719. . . . One cannot wait for a full development of his evidence if he has knowledge of the fraud. *Simon v. Goodyear Co. (C.C.A.)* 105 F. 573, 581, 52 L.R.A. 745. In this case the Holmans say they were discontented and suspicious from the first, and in 1922 or 1923 heard of the pooling agreement.”

See also:

Hampton v. Paramount Pictures Corp., 279 F. 2d 100 (9 Cir. 1960);

Yoshida v. Liberty Mut. Ins. Co., 240 F.2d 824, 830 (9 Cir. 1957);

Jeffrey v. Pioneer Placer Dredging Co., 50 F. Supp. 43 (D. Mont. 1943).

The propriety of applying the doctrine of estoppel to the entire claim of plaintiff herein is underlined

by the fact that her conduct, even before 1957, as the court below found, was completely inconsistent with all of her present claims, and led Harris Upham to deal with her on a basis where she accepted investment objectives however contrary she knew they were to her needs.

United States Fidelity & Guar. Co. v. Stewart's Downtown Motors, 336 F.2d 549 (9 Cir. 1964);

Mosley v. Magnolia Petroleum Co., 114 P.2d 740, 771-772 (N.M. 1941).

Whatever the duties of a broker, surely they do not go so far as to require constant questioning of apparently satisfied customers. The speed and fluctuation of the market, and the concomitant need for prompt action has historically led the courts to disapprove of belated customer complaints.

Law v. Cross, 66 U.S. (1 Black) 533, 539 (1861);

Brite v. W. J. Howey Co., 81 F.2d 840 (5 Cir. 1936);

Leviten v. Brickley, Mandeville & Wimple, Inc., 35 F.2d 825 (2 Cir. 1929);

In re Byrne, 32 F.2d 189 (2 Cir. 1929) (per Hand, J.);

Griffin v. Payne, 133 Cal. App. 363, 373 (1933).

The doctrine of laches, waiver and estoppel apply to past conduct. Most of the conduct of which plaintiff complained also occurred contemporaneously or after she was aware of all the facts and Wilder's practices, was suspicious of him, and lacked confidence

in him. The true doctrines applicable to a fact situation such as this are more than laches, waiver, and estoppel. They are also acquiescence, consent and participation. If Mrs. Hecht dealt with a registered representative in whom she had no confidence or trust, of whom she was suspicious and concerned on the very question of risk, and to whom she assigned functions personal to her and not authorized by Harris Upham, as she insists she did, surely she cannot complain. This, we suggest, is really the doctrine of the first decision of this Court in *Royal Air Properties Inc. v. Smith*, supra. The Security Acts were not intended to open the courts to such unjust enrichment, or to fulfillment of avaricious dreams sorely disappointed.

POINT IV

THE COURT MISCONCEIVED THE LAW OF "CHURNING"; IT FAILED TO FIND THE NECESSARY FACTS; AND THE FACTS FOUND ARE NOT SUPPORTED BY THE EVIDENCE

The term "churning" is a term of obloquy often left undefined. It is not used in any statute or regulation and does not *per se* constitute a violation of any law or regulation. Its use by the Securities and Exchange Commission in determining whether a broker has been guilty of a fraudulent or unfair trade practice under Rule 15c-1 or under the Rules of the National Association of Securities Dealers furnishes a guide to the nature of some "churning" activity, but not to what is or is not a fraud under Rule 10b-5. (See supra Point I-E.) Nor does a Securities and Exchange

Commission finding of a Rule 10b-5 violation require as much proof as that in an action at law for damages. The Commission may condemn a fraudulent practice without finding that the fraud succeeded in misleading anyone.

List v. Fashion Park, Inc., 340 F.2d 457 (2 Cir.), *cert. den.*, 382 U.S. 811 (1965);

Los Angeles Trust D. & Mtg. Co. v. SEC, 264 F.2d 199 (9 Cir. 1959);

Cf. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

Thus, a court's finding of churning without more is not a definitive or even significant finding of fact or law, and offers no hint whether the proper principles of law have been applied or the necessary facts proved to satisfy an action for damages under Rule 10b-5, particularly in the instant case.

The court below recited many definitions of churning, some of which included as standards "the suitability" of the activity in plaintiff's account to her "financial needs" and "circumstances". These standards are applicable to matters involving the Rules of the National Association of Securities Dealers. Earlier in its opinion the court barred such considerations as a basis for relief not only because it regarded them as legally inapplicable but also because of plaintiff's waiver, laches and estoppel. The court did not define precisely what it deemed to be churning as a violation of Rule 10b-5. It held Mrs. Hecht's account was churned in 1962 to 1964 when it was inactive. It appeared to believe that "churning" by any definition

and “naivete” are proof of fraud under Rule 10b-5, and that it did not need to find (1) a material fact undisclosed in a relationship of confidence which required disclosure of such fact, (2) reliance, or (3) damage proximately caused. It did not make such findings. The court confused “control” with confidence although the former only evidences the latter, and only the latter creates the need for disclosure. The opinion of the court is, therefore, clearly erroneous and contrary to law.

The court could not find damage from security “churning”; Mrs. Hecht’s account was profitable during every year she actively traded (Exs. 291, 324, 325).

A finding of fraud requires non-disclosure of material fact required to be disclosed because of relationships of the parties, or a misrepresentation relied upon.

Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228, 231 (D.D.C. 1949);

Royal Air Properties Inc. v. Smith, 312 F.2d 210 (9 Cir. 1962).

See cases cited *supra*, Point I.

Fraud in the context of a “churning” case under Rule 10b-5 requires as necessary, but not sufficient conditions, a relationship of confidence and trust, a broker’s dishonest assurances of his concern for the customer, and a customer unaware of the distinction between trading and investment, or other undisclosed material fact which would influence the judgment of a reasonable but uninformed person. Any other view

of the law would make of "churning" an absolute legal liability, and would be cynical, for one could "play along" with a broker's suggestion only to victimize him and make him surety for losses.

Rule 10b-5 has not been so interpreted.

Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9 Cir. 1962);

List v. Fashion Park, Inc., 340 F.2d 457 (2 Cir.), *cert. denied*, 382 U.S. 811 (1965);

Estate Counselling Serv. Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 532 (10 Cir. 1962);

Rosen v. Bergman, 40 F.R.D. 19 (S.D.N.Y. 1966) and the cases there cited;

Smith v. Wright, 188 C.A. 2d 790, 10 Cal. Rptr. 675 (1961).

See also:

A.L.I., Restatement of Torts §483 (2nd Ed. 1965);

Mula v. Meyer, 132 C.A. 2d 279, 282 P.2d 107, 109 (1955).

The facts in this case are totally foreign to these requirements of the law. Mrs. Hecht's many years in the market and her admissions cannot be forced into such a mold. The court did not find non-disclosure, a relationship of confidence requiring disclosure, or reliance. Mrs. Hecht was aware of the facts. She had no confidence in her broker; she did not rely on his assurances or ask him to determine the character of her account, risk, commissions and the like. Her suspicions, her distrust and her knowledge and ability

to appraise the fact that her orders were being violated and she was actively trading and speculating are sufficient to destroy any color of innocence or naivete.

Plaintiff's rights are not increased by urging Wilder was a "fiduciary". Fiduciary obligations originate in trust and are terminated by distrust.

Odorizzi v. Bloomfield School Dist., 246 Cal. App. 2d 123, 129, 54 Cal. Rptr. 533 (1966); *Abrams v. Bendat*, 165 Cal. App. 2d 89, 95, 331 P.2d 657, 660 (1958) and cases cited.

A person distrusted has no duty to state his opinion of active trading—it would serve no purpose.

At least one court has held that excessive trading *may* operate as a fraud, as it might.

Lorenz v. Watson, 258 F. Supp. 724 (E.D. Pa. 1966).

But churning need not be a fraud;²⁶ it cannot be in a relation of distrust. Furthermore ordinary common sense, educated by a few months of market experience especially in securities traded over national exchanges would educate even the naive and the imprudent to the fact that trading costs money, provided they read, as plaintiff did, and know the commissions incurred, as plaintiff did.

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bock, 247 F. Supp. 373 (S.D. Tex. 1965);

²⁶*Newkirk v. Hayden, Stone & Co.*, CCH Fed. Sec. L. Rep. ¶91,621 (S.D. Cal. 1965), on which the court relied was decided under Rule 15c 1-7. See also Point I-E, *supra*.

Carr v. Warner, 137 F. Supp. 611 (D. Mass. 1955);

Nash v. Warner, 137 F. Supp. 615 (D. Mass. 1955);

Cf. Adams v. Albany, 80 F. Supp. 876, 880-81 (S.D. Cal. 1948).

A "material misrepresentation" means a misrepresentation that would influence the judgment of a reasonable man without regard to individual personality. The securities market surely is not as simple from the point of view of the customer as many others, but it is not to be assumed that every customer is "dumb" and unaware of the self-interest of every broker, or totally unsuspecting. Even the Securities and Exchange Commission has not found "fraud" when the customer had some experience in market trading and did not oppose trading.

In re Walter S. Grubbs, 28 SEC 323 (1948).

The decision of the Commission in that case underlines the difference between views of the court below and the Commission with respect to churning, for the broker in that case induced his customer's confidence and assured her that he was acting in her best interests. She left the character of her account to him. The Commission found in fact that the broker had acted fraudulently by making excessive markups in over-the-counter trading which the customer could not contemplate and did not know. But one impropriety did not justify the finding of another impropriety. The customer's experience in trading barred

a finding of churning under Rule 10b-5. There was no reference to the risk involved. See also

Thomson & McKinnon, 35 SEC 451 (1953).

But even if the plaintiff were naive, had trusted and relied on her broker, had been misled by him to believe that he was serving her interests alone, and she understood she had an investment account, she would have nevertheless needed to prove, as Rule 15c 1-7 provides, a discretionary account; trading, excessive in size or frequency, having regard for "the resources and character of the account"; and that Wilder "fraudulently" disregarded her interests by the character and nature of his trading despite the absence of representation or non-disclosure.

We treat with each separately.

1. Discretionary Account.

The account was not discretionary; it could not be.²⁷ The "control" found by the court was not supported by the evidence; and the evidence does not suggest that Wilder could or did control the size or frequency of Mrs. Hecht's trading.

2. Excessive Trading for a Trading Account.

Since Mrs. Hecht agreed to a trading account, plaintiff would need to prove, and the court would need to find overtrading of a trading account. The court did not so find. It held Mrs. Hecht's account was churned because it was excessively traded for her "needs and circumstances". It combined her se-

²⁷Harris Upham does not accept discretionary accounts (R. 713).

curity and commodity account to make its finding, thereby giving to it an inevitable inaccuracy and a total irrelevance; for commodity trading is never related to a customer's "needs and circumstances" and security trading rarely is. These are standards applied when a security account is left to a broker to decide its character, because the customer does not know or is unable to judge what her needs and objectives are in relation to the market, and the broker has undertaken to serve the customer's "needs". They are not the standards of a security trading account, for the objective of a trading account has been determined to be trading and the customer's needs are no longer left for the broker's determination. Rule 15c 1-7 makes this eminently clear; the "character" of the account determines whether the size and frequency of trading is appropriate. Rule 15c 1-7 is also limited to securities.

The evidence before the court was not such that it could make a determination of excessive trading by the standards of a trading account. Such evidence would at a minimum include the market trends and activity with respect to each security sold and purchased and general market conditions, for it would be necessary to show that the account was traded without regard to the market. In addition, it would be necessary to have the testimony of an expert who stated as his opinion that one or more of the securities or all of them generally were traded without regard to the objectives of a trading account in the existing market.

L. B. Laboratories, Inc. v. Mitchell, 235 P.2d 253 (Cal.App. 1951).

No expert appeared to testify that Mrs. Hecht's account was excessively traded. The court assumed the same expertise as the Securities and Exchange Commission and the same authority of decision without fact finding as that permitted commissions and held that the account was churned—but not as a trading account.

A jury would not be permitted to find excessive trading in a trading account without more evidence and to hold that Mrs. Hecht, with almost thirty years of market experience could not comprehend what they could, that her account was being overtraded. A court has no greater authority.

The court relied on decisions of the Securities and Exchange Commission despite their limited application (see *supra*). They are in any event inapposite to the facts in this case. In the cases which have come before the Securities and Exchange Commission where excessive trading and churning were found to violate the Security Acts, the needs and objectives of the account were left to the broker. The broker gave assurances that he would handle the account in the best interests of the customer, in some instances even without regard to his own interest in commission. The Commission in each instance considered that the best interests of the customer required an investment account and that the customer had not consented to a trading account. It held the activity of the account excessive by standards of an investment account, not a trading account. In each instance where the Commission found excessive trading, the frequency and

size of the trading far exceeded the trading by plaintiff in the instant case. In no instance did the customer accede to a trading account for more than seven years.

3. The Broker's Disregard of Plaintiff's Interest.

Mrs. Hecht's account made over \$130,000 in security trading profits through 1961 (Ex. S-5), and her capital had increased by approximately the same amount despite net withdrawals and commodity losses (Exs. 284, 291, 292, 324). Thereafter, the account was turned over at a rate of approximately once in two years (Exs. 324, 325, S-9). Such facts raise doubt that Wilder had no regard for Mrs. Hecht's interests.

The court did not find that Mrs. Hecht's security account alone was traded without regard to her interests, as it needed to find. Such a finding would have been without foundation in fact, for there was no expert proof that the purchases made at Wilder's suggestion did not reflect honest market judgment in a trading account. Analysis of the Securities and Exchange Commission cases substantiates the need for expert proof. In the cases which have come before the Commission²⁸ the broker earned annually between 6.93% and 223% of the principal amount of his customer's account in commissions or profit. The median earned by Harris Upham was 1.89% of the principal amount of Mrs. Hecht's account annually (Exs. 324, 325). If it be considered that Mrs. Hecht's account

²⁸We have reviewed and statistically analyzed all published decisions.

was acknowledged by the court to be a trading account and not an investment account, as all the accounts considered by the Commission should have been in the opinion of the Commission, the conclusion that Wilder engaged in activity entirely for his own interests without regard to the interests of the plaintiff is surely unsupported.

As we have previously noted the court found that Wilder's security and commodity trading disregarded Mrs. Hecht's best interests. It reached this conclusion by combining commodity and security commissions. But combining these two different areas without separately understanding each of them serves to diffuse the court's finding and to make it of questionable value. We shall demonstrate *infra* the court failed to grasp the fundamentals of commodity trading. More important, the court failed to distinguish between self-interest and disregard of plaintiff's interest. The former is not a fraud unless the customer mistakes a brokerage firm for an eleemosynary institution. Mrs. Hecht did not make that mistake.

POINT V

PLAINTIFF FAILED TO PROVE CHURNING OF COMMODITIES

We are attaching in the addendum hereto one of the early commodity closeouts received by Mrs. Hecht. It will be seen why Mrs. Hecht had no difficulty in quickly grasping the nature of her activities (R. 2963).

The court's opinion appears to be based on: (1) Moral outrage that a lady should have engaged in

commodities, even though it found that she knew she was actively engaging in commodity speculation, and assumed the risks; (2) The commissions were large. But the court had no method of determining whether or not such commissions were in order in an active account; (3) Plaintiff took "large" positions in commodities. But this is not proof of churning, and the court had no way of knowing whether it was excessive trading or churning except by its own mistaken figures as to the quantity of Mrs. Hecht's purchases.

The court made no finding that the account in commodities was discretionary. Mrs. Hecht signed an agreement stating she understood her broker could not act on a discretionary basis without her written authorization (Exs. 94, JJJ). The court pointed to no evidence which indicated that plaintiff was misled. In fact, commodity closing statements far more than security statements leave no doubt in the customer's mind whether money has been made or lost and what the cost is. Plaintiff's expert testified anybody could read such statements and understand them immediately (R. 1834).

Plaintiff had an opportunity to read approximately 700 such statements while with Harris Upham over a period of seven years, and for one year before she became a customer of Harris Upham. It is conceivable that, as the court stated, "Mrs. Hecht was a relatively unsophisticated widow in the bad land of the commodities market", but she was very sophisticated as to profits and losses, commissions and risk, and even children know the larger the amount speculated the

greater the risk of loss. To charge her with lack of sophistication in this regard is to suggest that she was dim-witted, clearly contrary to the opinion of her doctors who testified on her behalf, and of the court.

The court below urges that Mrs. Hecht was forced to rely on Wilder for her commodity trading. Perhaps so, but only if she insisted upon trading through a man she did not trust. Her reliance went to selection, not to amount, "need" or "circumstance". There is no criticism of his selection in the record.

We do not discuss churning of commodities as a common law violation because under common law:

a) Mrs. Hecht's grant of discretion to her registered representative, if any, after signing a statement recognizing he could not accept such discretion made her responsible for his activity.

Clews v. Jamieson, 182 U.S. 461 (1901);

Winslow v. Mutual Life Ins. Co., 93 F.2d 802 (9 Cir. 1938);

New England Trust Co. v. Farr, 57 F.2d 103, 110 (1 Cir.), *cert. den.*, 287 U.S. 612 (1932);

Bosak v. Parrish, 252 N.Y. 212, 216, 169 N.E. 280 (1929) (Per Cardozo, J.) and cases there cited.

b) Liability could not be predicated on a breach of Section 20(a) of the Securities Exchange Act.

c) There is no proof or finding of common law fraud.

POINT VI

**HARRIS UPHAM IS NOT LIABLE UNDER SECTION 20(a)
OF THE SECURITIES EXCHANGE ACT**

The court below adverted to many standards and a variety of manuals with respect to supervising the activities of a brokerage house. It criticized Harris Upham because its manager did not personally meet Mrs. Hecht despite the fact that she came with Wilder from another brokerage house where he was a partner, and Wilder had for a long time been associated with Merrill Lynch, Pierce, Fenner & Beane. It failed to distinguish between negligence, if such it were, and "bad faith" or "participation" in any impropriety on the part of the partner of Harris Upham which would invoke Section 20(a).

Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689 (9 Cir. 1967), *cert. granted*, 390 U.S. 935 (1968);

Smith v. Bear, 237 F.2d 79, 88 (2 Cir. 1956).

The court inaccurately assumed that knowing one's customer was a standard provided by Section 20(a) rather than a Stock Exchange Rule of good practice (Rule 405, Ex. 268). It was not a rule of the National Association of Securities Dealers in 1957-1963 (R. 3254). It failed to realize that even those courts which have interpreted 20(a) to require supervision have limited such supervision to "internal" checks to assure that the Securities Exchange Act is not violated.

Lorenz v. Watson, 258 F. Supp. 724 (E.D. Pa. 1966);

Goodman v. H. Hentz & Co., 265 F. Supp. 440
(N.D. Ill. 1967).

The court did not find inadequate internal supervision.

Meeting Mrs. Hecht would not have helped. She did not disclose her illnesses even to Wilder (R. 2503, 2761-62, 3762-63). Her doctor thought she was financially astute. There is no reason to believe that Harris Upham's resident partner would have succeeded in dissuading her speculative proclivities when her lawyer, her husband, her brother-in-law and Wilder had failed. Nor does any law impose such a duty.

POINT VII

PLAINTIFF'S CLAIMS ARE BARRED BY THE STATUTE OF LIMITATIONS

The Statute of Limitations for fraud is three years. When facts related to the fraud are withheld the statute begins to run from the time the facts are known to the plaintiff. In this instance there is no evidence of facts withheld; therefore, assuming the "fraud" section of the statute applies, the statute should be deemed to run from the time the events occurred. Since plaintiff brought this action on September 20, 1965,²⁹ all acts prior to September 20, 1962 should be barred.

As we have noted plaintiff admitted her distrust and lack of confidence in Wilder from 1956. She admitted she knew her instructions were being violated, her

²⁹Except as to the Itek and Colonial transactions which were first claimed in June 1967 and pleaded over objection in March 1968 (R. 4745-4748).

securities sold contrary to her orders, and her alleged needs and objectives ignored. She felt her position was insecure. She was on notice and called upon to investigate. The statute began to run from that time.

Turner v. Lundquist, 377 F.2d 44 (9 Cir. 1967);

R. J. Reynolds Tobacco Co. v. Hudson, 314 F.2d 776, 786 (5 Cir. 1963);

Goldenberg v. Bache & Co., 270 F.2d 675 (5 Cir. 1959);

Fleishhacker v. Blum, 109 F.2d 543 (9 Cir. 1940);

Arkansas Natural Gas Co. v. Sartor, 78 F.2d 924 (5 Cir. 1935).

The standard of notice is not based on personal psychology. Emotional instability does not toll the statute even if it were proved. The only standard is that of the reasonably prudent man, and it does not require that plaintiff have all the information with respect to her rights. Suspicion alone suffices, and plaintiff was more than suspicious of Wilder.

Turner v. Lundquist, 377 F.2d 44 (9 Cir. 1967);
and cases cited supra.

POINT VIII

PLAINTIFF HAS FAILED TO PROVE DAMAGES

When a customer continually looks for "buys" in financial publications, and suggests them, but ultimately accepts some of her broker's recommendations, and when she is apprised of her commissions from the very beginning, and she knows brokers earn their living from commissions, what, if anything, is her

loss; indeed, what is the broker's impropriety? The answer is not to be found in such words as "control", "fiduciary duty", and the like; these are labels misplaced and distortive. Nor is it to be found in sympathy for plaintiff's imprudence. Surely she contributed to her own loss, and the statute which creates absolute liability is rare. This court has held Section 10b-5 is not among them. See *supra*, Point III.

In any event damages must be limited to the "risk" she did not "comprehend".

Section 28(a) of the Securities Exchange Act provides:

"... but no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfactions of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. . . ."

In *Robie v. Ofgant*, 306 F.2d 656, 660 (1 Cir. 1962), the court stated:

"[Plaintiff's] damages must be proven, that is, they must not be speculative, and he must not be made more than whole."

See also

Newton v. Rockwood, 261 F. Supp. 485 (D. Mass. 1966).

Future profits or what plaintiff would have made is not to be considered. The measure of damages is limited to actual loss which is proximately caused by the alleged breach of duty even in a "fiduciary" relationship.

Smith v. Bolles, 132 U.S. 125 (1889);
Estate Counselling Serv. Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10 Cir. 1962);
Miller Laundry Machinery Co. v. Works, 204 F. Supp. 364 (E.D. Pa 1962);
Gagne v. Bertran, 43 Cal. 2d 481, 275 P.2d 15 (1954);
Garstang v. Skinner, 165 Cal. 721, 134 P. 329 (1913);
Hayman v. Shoemake, 203 Cal. App. 2d 140, 21 Cal. Rptr. 519 (1962);
Dyer v. Hunter, 133 Cal. App. 267 (1933).

All or substantially all of the damages awarded by the court below are contrary to law, for the cases are uniform that penal damages may not be awarded under the Securities Exchange Act.

Meisel v. North Jersey Trust Co., 218 F. Supp. 274 (S.D.N.Y. 1963);
Globus v. Law Research Service, Inc., CCH Fed. Sec. L. Rep. ¶ 92226 (S.D.N.Y. 1968).

The total award exceeds plaintiff's loss fifty-fold.

We do not dispute the doctrines that a court may estimate damage when the precise amount is not determinable because of defendant's wrong, or that lack of precision does not defeat a claim. But these doctrines do not authorize damages patently not suffered, or empower a court to abdicate its duty to estimate and grant only damages suffered. Nor do they support a judgment for damages fifty times plaintiff's loss without regard to whether the damages were proximately caused by defendant's misconduct and plain-

tiff's failure to state she wanted her account differently handled.

Gratz v. Claughton, 187 F.2d 46 (2 Cir. 1951), on which the court below relied, dealt only with the method of computation under a "prophylactic" provision of the Act. It does not support any of the damages allowed in the instant case, and any inference that it does is contrary to *Blau v. Lehman*, 368 U.S. 403, 414 (1962).

See also

Peskin v. Phinney, 182 Cal. App. 2d 632, 636, 6 Cal. Rptr. 389 (1960).

The finding of laches, waiver and estoppel surely requires that damages be measured by the loss suffered by plaintiff, resulting from that impropriety committed by defendant of which plaintiff is entitled to complain. Plaintiff cannot claim for losses caused by trading activity she instigated, or to which she contributed. Plaintiff cannot have agreed to pay commission for an active security trading account, and later ask that the commissions be returned. Plaintiff cannot be barred, as the court found she was, from claiming the trading account was contrary to her instructions and unsuitable for her, and then have her commissions returned. Plaintiff cannot be barred, as the court found she was, from claiming that commodity trading was unsuitable and contrary to her instructions, and have her commodity commissions returned. Similarly, margin interest.

Such damages are penal in the context of the instant case because they were not proximately caused

by defendant's conduct. They followed plaintiff's acquiescence, consent and agreement.

The assumptions of the court below are: Wilder was a fiduciary; a fiduciary cannot profit from his own wrong. Therefore Harris Upham as a "controlling person" must return its profit. But legalistic labels serve only to confuse; they do not resolve the problem. A fiduciary obligation is one provided by law or undertaken by trust or other agreement.

In *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86 (1943), the court stated:

"We completely agree with the Commission that officers and directors who manage a holding company in process of reorganization under the Public Utility Holding Company Act of 1935 occupy positions of trust. We reject a lax view of fiduciary obligations and insist upon their scrupulous observance. [Citations omitted] But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"

An agent's fiduciary obligation is limited to the scope of his entrustment.

A.L.I., Restatement of Agency §13 (2d ed. 1958).

The fiduciary duty in this case was to execute plaintiff's order honestly in the appropriate market, and perhaps, to suggest good "trades".

3 Loss, op. cit. supra, pp 1505-1508.

If other duties were assumed by Wilder in 1955 they were surely disavowed with the understanding of Mrs. Hecht or at her insistence,³⁰ before she came to Harris Upham and when she learned to distrust him. Thus, "fiduciary obligation" is rendered meaningless by the court's finding of waiver, estoppel and laches and plaintiff's admissions.

If Harris Upham or Wilder had acted or agreed to act as fiduciaries, and had been faithless to their trust, then they would presumably not be entitled to the secret profits from the breach of their fiduciary duties. They would be entitled to expenses and the value of services rendered within plaintiff's agreement, and which did not arise from such breach. But Harris Upham and Wilder did not agree to act as fiduciaries and Mrs. Hecht had no confidence which is the essence of a fiduciary obligation. See

Odorizzi v. Bloomfield School Dist., 246 Cal.

App. 2d 123, 54 Cal. Rptr. 533 (1966);

Abrams v. Bendat, 165 Cal. App. 2d 89, 331

P. 2d 657 (1958).

Commissions were not secret; they were openly made and were for services Mrs. Hecht agreed to pay in May 1957. If earning commissions constitute a conflict of interest with a customer, it was conflict of interest known in advance and agreed upon. Thus restitution of all commissions is penal.

All that remains is the claim that if excessive trading is improper despite the absence of a fiduciary

³⁰She refused his suggestion for a trust at a bank.

relation and non-disclosure, then damages must be awarded for such excess. But there was no evidence and no finding that plaintiff's account was traded excessively for a trading account; the court could not and did not rely on "common knowledge". There is no such common knowledge.

We need not disagree with "churning" cases which have awarded commissions and the like. The facts distinguish them. They are cases in which there was no finding of laches, waiver and estoppel; ignorance was complete, the trading was fraudulently induced, and the entire account and substantially all the commission were not properly earned or were effectively "hidden". Above all there was a trust knowingly assumed and secretly abused. Mrs. Hecht suffered no such illusion and no such abuse.

Newkirk v. Hayden, Stone & Co., CCH Fed. Sec. L. Rep. ¶91621 (S.D. Cal. 1965) and *Stevens v. Abbott, Proctor & Paine*, CCH Fed. Sec. L. Rep. ¶92257 (E.D. Val. 1968) do not support the court's award for that reason. In *Newkirk* the relationship between commissions properly earned and those resulting from excessive trading were patently disproportionate and the court regarded the commissions properly earned as *de minimis*. In *Stevens* the court held the account should have been an investment account; substantial commissions were not appropriate and plaintiff, unlike Mrs. Hecht, either ignored them or was unaware of them.

We submit herewith detailed criticism of the damages awarded.

1. Commissions in Connection With the Securities Transactions.

Plaintiff claimed these commissions to be \$76,563, and the records disclose this figure (Exh. 283). The court noted the fact but it allowed \$91,000 on the theory that plaintiff paid additional commissions for which there was no proof.

The court awarded plaintiff commissions earned in 1962, 1963 and 1964, despite the fact that the security account was essentially inactive during those years. Such damages cannot be deemed to be related to churning. The sins of the past surely do not indict and convict the future. Perhaps the court was of the view that "excessive" trading is not a necessary condition of churning.

2. Commodities Commissions.

Commodities were very modestly traded the first year (Exh. 292). Obviously the court's award was not based on excessive trading.

3. Interest Paid.

Harris Upham received \$43,000 in interest on plaintiff's margin account but it did not earn this amount since it in turn paid interest. The difference between the interest received and interest paid by Harris Upham is $\frac{1}{2}\%$. Even in a trustee's accounting, more would not be allowed. The interest paid by Mrs. Hecht supported security purchases which overall earned \$123,000 in dividends and interest for her. (Ex. S-5). Her total gains, dividends and interest were \$244,275 after margin interest paid. (id.) There is no evidence such margin did not benefit plaintiff to the

full amount thereof. Plaintiff has thus been allowed a benefit without deduction, for a loss she did not suffer, and defendant charged for "profits" it did not make.

The interest charges paid by the plaintiff were not proximately caused by excessive trading of securities or commodities. A dormant margin account would have precisely the same charges as an active margin account. Margin is unrelated to the frequency of trading.

The court found Mrs. Hecht was aware of her interest charges. She was familiar with the cost of margin (R. 2521). She testified about margin and the amounts thereof. She had had a margin account since 1928.

4. Losses in Commodities.

The court allowed plaintiff's commodity losses despite its finding plaintiff knowingly assumed the risk of loss. Losses were not and could not conceivably be related to overtrading. In point of fact they were substantially the result of the DeAngelis scandal. The cases hold such damages as speculative.

Newkirk v. Hayden, Stone & Co., CCH Fed.

Sec. L. Rep. ¶ 91621 (S.D. Cal. 1965);

Stevens v. Abbott, Proctor & Payne, CCH Fed.

Sec. L. Rep. ¶ 92257 (E.D. Va. 1968).

Equity is even more opposed, for the court found plaintiff assumed the risk of trading losses in 1957. Even a trustee is not liable for losses unless he was prohibited from selling.

Cf. Estate of Talbot, 141 Cal. App. 2d 309, 296 P. 2d 848 (1956).

To establish such losses plaintiff would have needed to prove "disinterested malevolence", that Wilder deliberately lost her money. It is as conceivable that Mrs. Hecht suffered losses in commodities because she held positions too long as that she sold them too soon (Ex. 292). Neither was proved.

5. Loss of Income As a Result of Commodity Trading.

The damages awarded bear no relation to the amount her security account was deprived and the year of such deprivation.

Mrs. Hecht was at all times aware that her commodity trading required money (R. 2404-05, 2766-67). The award assumes Mrs. Hecht did not know what she was doing, a posture she has assumed, according to her doctors, most of her life when it was convenient. But the court did not make such finding; it found she knew what she was doing when she speculated in commodities. The award assumes, contrary to the court's finding of laches, waiver and estoppel, that Mrs. Hecht is entitled to recover for investments she did not make and in amounts investment could not have brought (R. 2193-95). The authorities are opposed. See all cases cited in this Point VIII.

6. Interest.

Interest should not have been allowed by the court since its award was not based on actual loss suffered by plaintiff.

POINT IX

THE ITEK AND COLONIAL TRANSACTIONS

By reason of the facts hereinabove set forth, it is respectfully submitted:

(a) These transactions are barred by the applicable Statute of Limitations; the claim was first made in June 1967 and first pleaded in 1968 (R. 4745-4748).

Firchau v. Diamond Nat'l. Corp., 345 F.2d 269 (9 Cir. 1965);

Tessier v. United States, 269 F.2d 305, 308 (1 Cir. 1959).

See also Point VII, *supra*.

(b) Plaintiff's gift of Colonial stock does not create liability under state or federal law.

(c) The court had no authority to find Harris Upham guilty of impropriety in these transactions without first giving it an opportunity to cross-examine the plaintiff and tender evidence. Its offer to do so after making its determination surely did not cure this defect. No party is required to try a case before a court which had judged the facts before hearing all the evidence.

Armstrong Cork Co. v. Lyons, 366 F.2d 206 (8 Cir. 1966).

Sylvan Beach Inc. v. Koch, 140 F.2d 852, 861 (8 Cir. 1944).

(d) The Itek and Colonial transactions were private dealings between the plaintiff and defendant's registered representative, as plaintiff knew and recognized. They do not invoke Section 20(a) of the Securities Exchange Act, even if the Act were applicable to private transactions as such, which appears doubtful. The use of an interstate instrumentality is more than doubtful.

(e) Wilder had no authority to act on behalf of Harris Upham, and the court made no finding of apparent authority. Harris Upham did not and could not participate in the transactions and did not receive any benefits of the transactions. There is no law whereby liability for the private business of two persons can be imposed upon a third. Agency is not even in issue.

"An act of a servant is not within the scope of employment if it is done with no intention to perform it as a part of or incident to a service on account of which he is employed."

(A.L.I., Restatement of Agency, Section 235 (2d ed. 1958)).

Bushey & Sons, Inc. v. United States, 398 F.2d 167 (2 Cir. 1968);

Kamen & Co. v. Paul H. Aschkar & Co., 382 F.2d 689 (9 Cir. 1967), *Cert. granted*, 390 U.S. 935 (1968).

CONCLUSION

It is respectfully submitted that the judgment of the court below be reversed and the complaint dismissed, with costs and disbursements in both courts.

Dated, San Francisco, California,
December 30, 1968.

Respectfully submitted,
EMANUEL BECKER,
THOMAS A. H. HARTWELL,
COOLEY, CROWLEY, GAITHER, GODWARD,
CASTRO & HUDDLESON,
Attorneys for Defendants
Harris, Upham & Co., et ano.

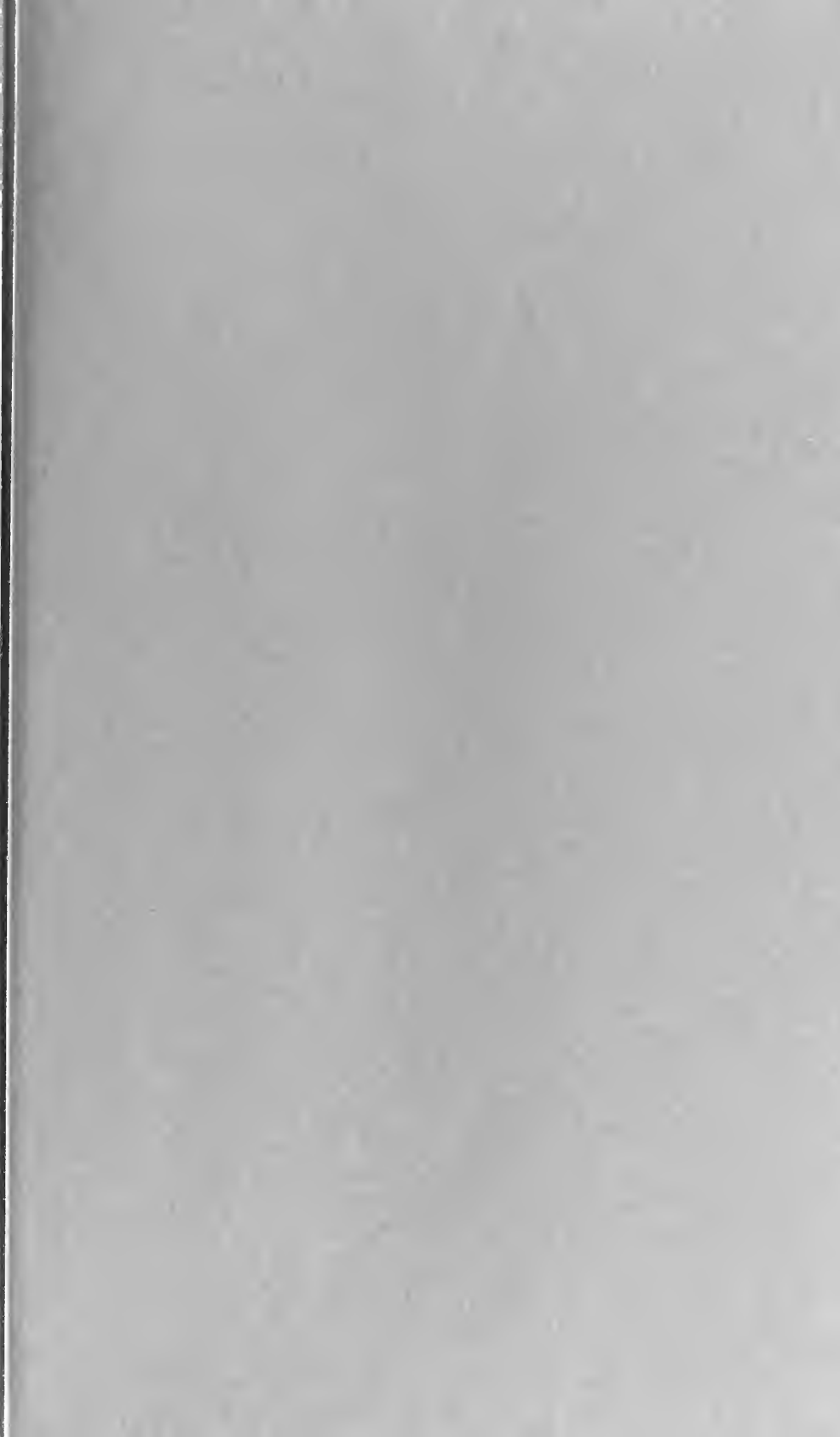




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**RESPONSIVE BRIEF TO PLAINTIFF'S
"OPENING BRIEF" ON APPEAL—No. 23,017**

INTRODUCTION AND STATEMENT OF ISSUES

Plaintiff appeals from the judgment of the court below, claiming she is entitled to additional damages. Unlike the appeal of Harris, Upham & Co. (hereinafter referred to as Harris Upham), none of her arguments are based on the court's findings, admissions against interest or written documentary proof. She urges (1) the facts found by the court below were "clearly erroneous" because it refused to accept her testimony even though it was self-contradicted in almost every respect; (2) damages may be awarded to her for moneys she might have made or paid out during seven years although all her activities had her full understanding, consent, approval and acquiescence; and (3) a broker's "fiduciary duty" eliminates the need to find that damages were proximately caused by a breach of duty and may be awarded (without proof) irrespective of the obligations owed by the broker as a "fiduciary" or of the extent or manner in which such obligations were dishonored. All of the foregoing assumptions are contrary to law. That any one of them is contrary to law is sufficient to dispose of plaintiff's appeal.

Plaintiff's appeal is protective; it is intended to support the award of the court below which suffers from three major deficiencies:

(1) The damages awarded are far in excess of actual loss, contrary to Section 28(a) of the Securities

Exchange Act. Most of the damages awarded were unrelated to loss and those presumably related are speculative and indiscriminately exaggerated.

(2) They are unrelated to the "risk" which the court found plaintiff did not "comprehend". What is more the court failed to describe this risk.

(3) They are in excess of those proximately arising from a plaintiff misled. The court below did not find plaintiff was misled or that she suffered loss because she was misled.

"Churning" does not necessarily result in loss or damage as the court below incorrectly assumed. It has been condemned by Securities and Exchange rule in over-the-counter transactions. Misrepresentation in security transactions, to which "churning" might or might not contribute, is generally condemned by the Security Acts and the Commission. No doubt a civil right of action arises when persons are deceived, providing they have been actually damaged "on account of the act complained of" (Section 28(a) of the Securities Exchange Act). But even if an act condemns, damages cannot be awarded where none are suffered and none are proved. People have made money by actively trading. They are not necessarily injured thereby. A broker who overtrades an account without customer approval may violate Rule 15c1-7 or National Association of Securities Dealers rules 1, 2 or 15. Even if he makes money for his customer, the National Association of Securities Dealers and the Securities and Exchange Commission may perhaps complain. But not the customer! This principle has been

ignored in the instant case. Plaintiff's profitable security trading account did not necessarily damage the plaintiff; and plaintiff offered no evidence that trading as such damaged her.

This consideration and others led plaintiff to bring an action for breach of trust, really for account mismanagement which encompassed commodities,¹ rather than for violation of Rule 10b-5. Jurisdiction should have been refused in the first place. But the action as alleged failed because plaintiff had no trust, offered no proof of mismanagement or loss therefrom and, as the court found, had agreed to a trading account before she came to Harris Upham. Nevertheless, trust "damages", not actual damages, have been awarded as if the account were left entirely to Harris Upham and plaintiff did not know and had not agreed to her activity. The court having thus opened the door to recovery without loss, plaintiff sees no reason why there needs to be limit, and thereby dramatically demonstrates by *reductio ad absurdum* the error in the judgment of the court below.

We have generally reviewed the facts and the law in our principal brief. We address ourselves in this brief to the specific statements of fact and argument in plaintiff's "Opening Brief", largely in the order in which they appear, and where practical, we refer to the page and the caption employed by the plaintiff.

¹It was therefore not within the Securities Exchange Act and the scope of federal jurisdiction.

**PLAINTIFF'S MOTION FOR LEAVE TO OFFER ADDITIONAL
EVIDENCE IN THE COURT BELOW**

Plaintiff moved in the court below for leave to reopen the judgment and to offer evidence that Harris Upham was censured (but not fined) in 1958 by the National Association of Securities Dealers for inadequate supervision. Her stated purpose was that such evidence should be considered on the issue of punitive damages.² But the facts submitted to the court below were not limited to the censure or to punitive damages. Indeed, the conduct of Harris Upham which led to censure was not stated, but the entire opinion of the Regional Committee of the National Association of Securities Dealers in the complaint of Mrs. Hecht was set forth despite its obvious lack of relevance and its impropriety. The motion was denied on the ground that the evidence would be purely cumulative and would not have changed the judgment of the court.

Plaintiff has now brought the same motion before this court but does not seriously urge it. She has, however, used it as a pretext to attach as an appendix to her brief the decision of the Regional Committee, and improperly quotes that opinion *in extenso* throughout her brief with respect to questions that are in no manner related to supervision or to punitive damages. Thus, plaintiff is attempting to influence this Court's judgment as to the merits of her appeal by asking it to consider the Regional Committee's

²In fact, the previous censure of Harris Upham was before the court below during the trial (see Appendix B to Plaintiff's Opening Brief, p. 35, fn. 1).

findings. We recognize that this court will only consider the record before it, and will not consider the opinion of the Regional Committee. However, in view of plaintiff's quotations we think it in order to point out the following facts, all of which appear in that opinion:

1. The Committee did not see or hear Mrs. Hecht nor any of her doctors. Relying on the record before this court, and totally in contradiction to the findings of the court below, and the testimony of plaintiff's doctors, this committee of laymen, purporting to have studied the entire record before this court, held:

"We have reviewed carefully the entire record in this case and *we are convinced that Mrs. Hecht, at least during the years 1930 until 1955, had acquired enough knowledge of the securities market to exercise adequate judgment in her dealings with securities dealers.* However, it is also apparent that after the death of her husband, there was a progressive deterioration of her mental and physical well-being. . . .

"It must be noted that the Committee does not consider this earlier period of securities dealings to be of importance in reaching our decision because complainant's needs, objectives, and mental and physical condition were then vastly different." (Emphasis supplied)

In other parts of the opinion the committee stated Mrs. Hecht to be of "failing faculties" (Appendix, p. 21).

The opinion of the Committee is internally consistent, but at the expense of complete record distor-

tion. Without any immediate or nodding acquaintance with the facts or the record, and unhampered by any regard for them, the Committee judged Mrs. Hecht's mental faculties. The doctors who, unlike the Committee, saw, talked to and observed Mrs. Hecht, were not prepared to say that Mrs. Hecht lacked the necessary ability to be a successful business woman (R. 317, 787, 788); they did not see any evidence of deterioration (see *infra*). Quite the contrary.

2. The Committee did not find excessive trading of a trading account; it held "unsuitable" the trading of securities and commodities by a lady of "failing faculties." The court below found Mrs. Hecht was barred from making these very claims because of her knowledge and understanding.

The opinion of the Regional Committee will be reviewed by a committee of the Board of Governors of the National Association of Securities Dealers *de novo*.

PLAINTIFF'S STATEMENT OF FACTS

The Plaintiff (pp. 6 et seq., plff.'s brief):

Plaintiff's brief contends Mrs. Hecht was lacking in normal intelligence, could not read her statements, and had suffered mental illness. The record and findings are to the contrary. There is no evidence that Mrs. Hecht "suffered an acute brain syndrome caused by a cerebral infarction" in 1955 (R. 376, 795). Her doctor testified she suffered from a toxic psychosis in 1955 which might have been due to excessive con-

sumption of barbiturates, alcohol, of both³ (R. 755, 769, 770, 771, 775, 795, 807). She is competent (R. 317-9, 323, 333, 356), very much the same as she always has been (R. 321). She has not suffered brain damage; the brain wave tests, according to her doctors, prove nothing (R. 322, 323, 376). She was upset in 1955 due to money worries and litigation regarding her husband's estate (R. 757).

She is normal (R. 304). She was "disorganized" according to her accountant, only in her ability to keep her druggist and doctor bills for tax deductions (R. 3411). He agreed she had a mind of her own (R. 3330). According to her doctors money was always on her mind (R. 781, 787, 796) and her forgetfulness about nonfinancial matters a long standing personality trait (R. 308).

Despite Mrs. Hecht's "dependent and passive temperament which has limited her ability to raise outward objections to what are really unpleasant or uneasy situations for her" (p. 8), she blamed one doctor for her troubles (R. 776-78) and discharged another doctor because she considered his charges too high (R. 339-40).

There are many references in plaintiff's brief to statements made by her that she did not understand a variety of things, but she understood these very same things when it suited her purposes (see our principal brief; R. 2703-05, 2836, 2960-64), even on one occasion when her counsel sought to mislead the

³Complete lack of regard for truth telling is not uncommon among people with such habits.

court (R. 2960-63). We invite the court's attention to each reference in plaintiff's brief intended to establish her ignorance or lack of understanding. They conclusively prove she and her counsel sought to make her out to be an imbecile, and by their exaggeration stand condemned.

Counsel for plaintiff are aware of the "clearly erroneous" rule, and cannot seriously believe the record distortions in their brief will assist this court. Their brief is really a plea for sympathy for an elderly lady; they hope this court will be moved to judge by sympathy rather than by law. We note their reliance on the "big pocket theory" in describing defendant.

Defendants (pp. 9 and 10, plff.'s brief):

Plaintiff states that no officer of Harris Upham "was specifically placed in charge of or made responsible for supervisory or compliance matters . . .". This statement is made without record reference and is unfounded. Nor is local supervision contrary to established or permitted practice (R. 3251); in fact there is a supervising partner over every office. Mr. Mejia was a supervising partner of the San Francisco office.

The Relationship Between Mr. Wilder and Mrs. Hecht (p. 12, plff.'s brief):

Plaintiff urges that Mr. Wilder acted as "plaintiff's advisor" from 1955 and had complete charge of her investment affairs until March 1964. This conclusion is without record support, except for statements appearing in some of Mrs. Hecht's wills drafted by a lawyer (not admitted against Harris Upham), and

statements made by accountants that they understood Wilder was Mrs. Hecht's financial adviser. Neither is proof of the fact. The proof goes in all directions. Mrs. Hecht testified Wilder did not advise her. He did what he wanted despite her protest and offered neither advise nor explanation. He sold her "blue chips" despite her contrary instructions and despite her objections. He took her account out of Walston & Co. and put it into Hooker & Fay without her consent; he had securities from her husband's estate transferred to Hooker & Fay without her consent,⁴ he transferred her account from Hooker & Fay to Harris Upham without her consent.⁵ She distrusted him from 1956. These and other contradictory theses are repeated in plaintiff's brief. The court is asked to believe all, and hold the findings of the court below clearly erroneous.

Plaintiff repeats in this part of her brief, as well as on page 25, without benefit of record reference, the claim that Mrs. Hecht engaged in 8,900 or 9,000 "commodity transactions [which] were initiated solely by Mr. Wilder." The statement is unsupported and is contrary to the facts. The facts are:

1. There is nothing in the record to indicate that Wilder initiated a single commodity transaction. He named many future commodity markets; but that is not the same as recommending whether or when they

⁴Presumably with the connivance of very distinguished counsel who handled her interest in her husband's estate.

⁵Mrs. Hecht signed all the necessary documents.

should be purchased or sold, the delivery date, or the quantity. None of these are the subject of record proof favorable or unfavorable to plaintiff. All the findings of the court and the arguments in plaintiff's brief on this issue are surmise.

2. It is not possible from most commodity statements to determine whether the person purchased or sold one or more than one contract, since the purchase and sales slips deal with quantities rather than contracts. Presumably, if one knew the quantity constituting a contract under the rules of a particular exchange at any given time, it would be possible to determine the number of contracts. No such determination was made at the trial, nor is the necessary data in the record. Assuming, however, that Mrs. Hecht purchased or sold 4,500 contracts and subsequently closed them out, this is far different from 9,000 "commodity transactions". Single contracts assumed and closed out are perhaps more analagous, although not the same, as the purchase and sale of five or ten shares of stock—which is not a characteristic purchase. An average commodity transaction might well consist of five or ten contracts just as shares are normally bought in units of 100 or multiples thereof. 5,000 shares purchased and sold would not be, in any meaningful sense, 10,000 transactions or even 100 transactions. The court below misunderstood, and the findings made which relied thereon are clearly erroneous. The only significant statement is that Mrs. Hecht assumed and closed out approximately 700 positions. Even this number is not especially significant in determining Mrs. Hecht's trad-

ing or risk since she straddled in 1958⁶ (the holding of a purchase and sale position in the same commodity for different months), a common tax delay device which does not involve any substantial risk (R. 1758, 2150). She may have otherwise protected positions. Plaintiff's figure surely frightens the uninitiated and obviously impressed the court below sufficiently that it erred.

We have called attention in our principal brief to the fact that commissions in commodity transactions are for a "round trip", i.e., a single commission is charged for purchase and sale (R. 1740).

On page 15, plaintiff's brief notes that the court found plaintiff's "summaries were prepared in a manner to 'allay any fear that the volume and frequency of the trading was excessive'" and that the last summary dated March 29, 1963 "was misleading and 'would have given the impression that no excessive trading was going on.'" The court did not find that in fact Mrs. Hecht's fears were allayed; her testimony was to the contrary.

The Wilder statements refer only to the position of plaintiff's security accounts, portfolio, profit, loss and the like. They do not refer to any fact conceivably related to trading volume. Plaintiff's brief and the court's findings are clearly erroneous and indicate a novel view of churning and excessive trading. Trading is better indicated by the number of slips

⁶The court found she understood and waived any claims arising therefrom.

one receives, and the length of time securities are held.

None of the statements were materially inaccurate except for an omission in the March 29, 1963 statement. The fact that some of Wilder's statements referred to gains and the like, as noted by the court, did not make them inaccurate or confusing. Mrs. Hecht really did make substantial gains, and her account improved in value through 1961.

Moreover this did not mislead. Mrs. Hecht testified she did not look at these statements and she distrusted all of Wilder's explanations of the status of her account.⁷ If Wilder prepared these statements to allay concern on the part of Mrs. Hecht, they failed their mission. Mrs. Hecht testified she knew she lost money at the time it occurred and she knew her commissions were "accumulating".

On page 15 plaintiff's brief states "Mr. Wilder's misuse of his dominion and control over Mrs. Hecht and her financial affairs is best illuminated by the two specific instances in which he converted her securities." The transactions referred to are Itek and Colonial. The court did not find that the securities were converted. Moreover, conversion does not come under the Security Acts. But the fact is the court might well have regarded these transactions as best illuminating the relationship between Mrs. Hecht and

⁷The court noted Wilder testified he discussed her statements with her; it recognized Mrs. Hecht disagreed. The important fact is she did not listen, and did not believe, and therefore could not rely.

Mr. Wilder, as plaintiff states. If it did so, or if it significantly affected the court's opinion, then the judgment of the court below must be reversed in its entirety. We have preferred not to argue this issue because we regard the conduct of the court below extraordinary, and this court's expertise far greater than ours. These transactions were not pleaded and were not admitted against Harris Upham before decision was reached, with Harris Upham having no opportunity to cross-examine or conduct examinations before trial on these matters before such decision. The court reopened the cause as to these items, but not generally, and such reopening could not and did not serve a useful purpose.

Churning and Unsuitable Management of the Account (pp. 16 et seq., plff.'s brief):

Mrs. Hecht testified that in 1955 her understanding of her objectives and needs were "the preservation of her capital and the receipt of a regular dividend income". (p. 16). She claims she stated these objectives and needs to Wilder in 1955 (see R. 2407, 2427, 2895, 2954-57, 3036), and that they were ignored by Wilder from the very first despite her remonstrations (R. 2491, 2704-07, 2959). Thus, all of plaintiff's testimony as to her lack of sophistication, understanding and ability as to financial matters is self-contradicted. It required the court's conclusions with respect to plaintiff's knowledge and understanding, and in the light of plaintiff's other testimony makes unsupportable the conclusion that she was "naive" in any way significant under the Security Laws.

On pages 17 and 18, plaintiff quotes *in extenso* from the opinion of the Regional Committee of the National Association of Securities Dealers on the question of the suitability of plaintiff's security and commodity accounts, despite the fact that these findings are not before this court for any purpose. In fact, plaintiff's entire claim of unsuitability is predicated on the assumption that this court will accept such findings in lieu of the court's findings. It would have post-trial expertise and evidence substituted for proof lacking at the trial, without the risk of cross-examination. The findings of the Committee are in fact contrary to those of the court below. It held Mrs. Hecht consented to a trading account; but the Committee did not believe it. It favored surmise to record study and fact finding.

On page 18 of plaintiff's brief, reference is made to principal markups of \$15,000 in addition to \$76,000 in commissions. There is no record reference in plaintiff's brief to sustain this except the testimony of the secretary of the Regional Committee of the National Association of Securities Dealers who stated he knew Harris Upham's commissions were well within a 3% figure (R. 3206-12). \$15,000 represents 3% of plaintiff's principal transactions. The court failed to consider (a) the commission ordinarily charged by Harris Upham in over-the-counter transactions is the Stock Exchange commission which averages about 1%

(R. 587-90, 623); (b) the NASD representative recognized and noted that many riskless transactions are secondary underwritings for which no commissions are charged (the seller pays) (R. 3261-63); and (c) there is nothing in the record to indicate a charge to Mrs. Hecht for any of these transactions (R. 3221-24).

On pages 21 and 22 of plaintiff's brief, it is urged that 40% of the securities in Mrs. Hecht's account based upon cost "were given speculative ratings by independent rating services." 40% includes securities not rated by independent rating services. The independent rating services do not rate banks, financial companies, aircraft manufacturers and others (R. 1987-88). Obviously, not all banks or financial companies, or aircraft companies (such as Douglass Aircraft) are necessarily "speculative" investments.

Plaintiff listed at pretrial a group of companies in which Mrs. Hecht had invested and which she regarded as speculative (Ex. ZZZZ; pp. 7 and 8 of pretrial statement, T. 242, 243). Based on market value these securities constituted the following percentages of Mrs. Hecht's total account at the end of each year:

| | | |
|------|------|------------|
| 1958 | 6.7% | |
| 1959 | 4.7% | |
| 1960 | 7.3% | |
| 1961 | 13.% | |
| 1962 | .7% | |
| 1963 | .2% | (Ex. S-10) |

Not all of these securities were criticized in plaintiff's schedule of securities as being "below average" in Standard and Poors rating (Ex. 31). The percentages of Mrs. Hecht's securities thus listed and criticized were as follows:

| | |
|------|----------------|
| 1958 | 2.7% |
| 1959 | 4.2% |
| 1960 | 4.2% |
| 1961 | 3.7% |
| 1962 | .6% |
| 1963 | .1% (Ex. S-10) |

Mrs. Hecht's present financial adviser who appeared as a witness to testify on her behalf was not prepared to criticize Mrs. Hecht's account in March 1964 from the point of view of a trading account, although invited to do so (R. 1977). Among the securities which Mrs. Hecht held at the time the account was transferred from Harris Upham and in which the market price was lower than cost were American Machine and Foundary, Pacific Tel & Tel, Western Electric, General Instruments, Ampex (initiated by her), Anaconda Copper and A T & T (R. 1910 et seq.). There is nothing in the record to suggest that Mrs. Hecht lost money as result of any of her "speculative securities". Nothing in the record or in the court's opinion suggests it. Plaintiff's security account made money overall.

Since plaintiff is critical of the "suitability" of her account, and the court called attention to the status of the account in March 1964, but made no finding as to suitability as of that time or any other time,

it is in order to call attention to the following: From 1957 through 1964 Mrs. Hecht's account enjoyed \$164,773.80 in gains and \$123,106.28 in interest and dividends (S-5). It was charged \$43,604.81 in margin interest, and showed a net income of \$244,275.27. The income and percentage of return during the full calendar years when the account was maintained at Harris Upham were as follows (Ex. S-11):

| | <u>Net Income Including Capital Gains After Interest Charges</u> | <u>Percentage of Return on Capital</u> |
|------|--|--|
| 1958 | \$72,729 | 16.9 |
| 1959 | 43,663 | 9.8 |
| 1960 | 35,171 | 7.9 |
| 1961 | 60,094 | 13.5 |
| 1962 | 22,265 | 4.7 |
| 1963 | 28,724 | 6.5 |

Mrs. Hecht also had unrealized capital gains of \$5,485.00 in 1963 and \$10,714 for the three months ending March 1964 (Ex. S-3).

According to the testimony of her financial adviser (R. 2193) she could have expected to earn between 3½% and 4% on "blue chip" stocks.

"Short Sales" (p. 23, plff.'s brief):

Mrs. Hecht did not engage in "short sales" as that term is commonly understood. She sold "against the box", i.e., securities she actually owned but did not want to deliver out immediately (R. 286, 287, 2167). This is a common practice which has none of the ordinary speculative aspects of short sales. If there

was a loss in these short sales there was a comparable gain in the long position. The court held her knowledge and understanding barred this claim.

Commodities Transactions (p. 23, plff.'s brief):

Plaintiff's brief states that Mrs. Hecht was unaware of the transfer of moneys to commodities. The court did not so find; it barred her claim on this ground. She testified that money was being continuously demanded of her to put into commodities (R. 2405) and she signed agreements permitting such transfers (Exs. 95, 96).

"Selective Close-Out Scheme" (p. 26, plff.'s brief):

The entire text with respect to the "selective close-out scheme" is an imaginative figment exaggerated in direct proportion to its lack of record support. No proceeding was ever instituted by the Commodities Exchange Authority against Harris Upham.⁸ There was no impropriety in "selective closeouts" in 1963, nor is there today if such closeouts have the permission of the customer. There is no testimony in the record that the closeouts did not have the permission of Mrs. Hecht. The issue was not raised during the trial, and defendants offered no proof with respect to plaintiff's permission. If plaintiff understood her closeouts, then her complaint fails entirely because she was waiting to see how she would come out overall for seven years.

⁸Counsel for plaintiff appeared before a CEA hearing examiner and urged such action.

“False Summary of March 29, 1963” (p. 28, plff.’s brief):

It may be seen from the summary printed on page 28 of plaintiff’s brief that there is nothing in it which bears any relationship to excessive trading, despite the court’s finding and plaintiff’s contention. Mrs. Hecht’s account had long since ceased to be actively traded (see Exs. S-9, 324, 325), so that she could not have relied thereon to her damage. We have heretofore noted that Mrs. Hecht claimed ignorance of any statements, that she did not trust Wilder’s advice as to her financial condition, and she knew she was losing money.

The statement of operations analyzed in plaintiff’s brief is a statement of Wilder’s stewardship from 1955 when, according to plaintiff (p. 12 of her brief) Wilder first began to advise Mrs. Hecht’s attorney “during the probate proceedings regarding the sale of securities . . .”. It is not a document relating to Mrs. Hecht’s activities while with Harris Upham. It was prepared without the authority of Harris Upham (R. 733).

RESPONSE TO PLAINTIFF’S ARGUMENTS

I

ESTOPPEL, WAIVER AND LACHES

(pp. 32 et seq. of plff.’s brief)

Plaintiff’s brief ignores a fundamental fact: if the doctrine of estoppel, waiver and laches had never been invented, Mrs. Hecht would not be entitled to recover, because knowing what she did she could not

be misled; and since she was not misled she is not entitled to relief under the Securities Exchange Act. We have reviewed the apposite provisions of the Act in our principal brief; perhaps unnecessarily so, for the Securities Exchange Act is a disclosure act, and disclosure satisfies all of its requirements.

SEC v. Capital Gains Research Bureau, Inc.,
375 U.S. 180 (1963).

Nor does it mandate damages where the plaintiff did not rely, was not misled and was not injured by the act complained of.

The court's finding of waiver, estoppel and laches did not prevent it from maximizing plaintiff's damage award. But it could not countenance the claims for which plaintiff contends even if it had not found waiver estoppel and laches:

(1) It could not award damages because plaintiff's original portfolio was sold; Mrs. Hecht testified she knew her original portfolio was being sold at the time it occurred; some of it had been sold and some of it repurchased before January 1957. She made records of some sales (Ex. M), she read the records of other sales (R. 2523, 2593, 2707, 2774-76, 2847, 2863-64, 2960-62), and testified she complained about them to Wilder at the time (R. 2705-07). The Statute of Limitations would in any event have barred these claims.

(2) It could not grant damages for "unsuitable investments" since no "unsuitable investments" were found and no evidence offered that "unsuitable investments" produced losses. Here, too, plaintiff's

knowledge would bar her claim and the Statute of Limitations would be applicable.

We suggest that plaintiff's difference with the court's finding of waiver, estoppel and laches is really an attempt to buttress a judgment which cannot be upheld as the court's findings require a judgment for Harris Upham under this court's opinion in *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9 Cir. 1962).

The court below did not fault Mrs. Hecht's intelligence, only her personal characteristics, social maladjustments which her doctors agreed are of long standing (R. 308, 317, 321, 777-79, 809). Her "erratic" personality is not to be equated with mental imbalance. Nor can it properly be a subject of judicial consideration; it is all too common, or at least too commonly ascribed. Mrs. Hecht's doctors testified they found nothing to disqualify her business judgment (R. 787-88, 317).

Estoppel:

It serves no purpose to review all the cases cited in the argument made by plaintiff with respect to the doctrine of estoppel. This court has in numerous decisions recited the requirements, e.g., footnotes 1-3 in *Royal Air Properties, Inc. v. Smith* 333 F.2d 568, 570 (9 Cir. 1964). Intentional misrepresentation by plaintiff is not one of them, as plaintiff contends. The court below made each of the findings necessary and its findings are well supported. The fact that Mrs. Hecht gave instructions as to how her account was to be handled to satisfy her needs and circumstances,

that she knew such instructions were being violated before she came to Harris Upham but permitted Harris Upham to continue her account as a trading account, as it did, would suffice. Nothing in the record suggests that the management of Mrs. Hecht's account, if it was not managed entirely by her, was inappropriate to a trading account. A trading account was perhaps contrary to her needs and circumstances and her claimed objectives. But all of this she knew and understood for eight years by her own admission. The court so found.

Exactly what plaintiff did not know is the essential enigma of the findings and judgment of the court below. It is not resolved by the court's statement she did not comprehend the risk of "excessive" trading. What risk? What failure of comprehension? Neither the court's opinion, the record, or any considered judgment furnishes an answer, especially since the court found she understood the risks of an actively traded securities account and a "speculative" commodities account. Is the court's finding really a finding of imprudence, and has it mistakenly identified "churning" with all imprudent customer conduct which the broker does not oppose?

Plaintiff would escape this enigma and the law which requires reversal of the judgment by changing the facts. She maintains that she was the victim of a "calculated, deliberate and fraudulent scheme and that the true facts concerning the transactions in and the condition of her account were misrepresented to and concealed from her" (p. 36), whereas defendant

knew all the facts. The court did not find such schemes and only commented on the ambiguity of a Wilder statement of her security account made long after it ceased to be active. Active trading in reliance on misrepresentation or fact concealed was not found. Furthermore, Mrs. Hecht was well aware of all the facts with respect to her losses and her commissions, the latter being the only factor relevant to a determination of excessive trading (R. 2703-04, 2836). Nor was the court below prepared to find that Harris Upham was aware that Mrs. Hecht wanted her account handled differently. It found Mrs. Hecht knew and acquiesced in the manner in which her account was handled, and permitted Harris Upham to rely on her acquiescence.

Waiver (p. 36 of plff.'s brief):

Plaintiff cites *Wilko v. Swan*, 346 U.S. 427 (1953) that waiver is not permissible under the Securities Exchange Act. *Wilko v. Swan* was decided under Section 14 of the Securities Act which prohibits waiver of the Act's protection in advance of breach.

Plaintiff argues that waiver requires "express, intentional and unequivocal conduct" evidencing the waiver. The court found precisely such conduct in the seven years that Mrs. Hecht received, analyzed and discussed her purchases and sales. The court read *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568 (9 Cir. 1964) and found plaintiff had done precisely what this Court deems necessary to "waive" rights.

Plaintiff's brief insists, without record support, that she did not know that she owned non-dividend paying

securities. Mrs. Hecht did not so testify. After first denying that she could recognize from vouchers attached to her checks which of her checks were dividend payments, she later admitted she could (R. 2725, 2907). Plaintiff argues, and the court below stated, that Mrs. Hecht could not tell from her dividend check the specific dividends she was receiving. We know of no broker whose check vouchers even today indicates that. But Mrs. Hecht could and did read her monthly statements which recited the precise amount of dividend received on each security, and the amount of her margin loans and interest charges for such margin loans (R. 2774-76). It does not help to say that Mrs. Hecht had only one monthly statement at a time and did not realize the situation overall. She admitted she knew her losses overall and was aware of her losses as they occurred without the benefit of her purchase slips (R. 2703-04). Her annual dividends are recited in her income tax return which she kept. She also had her deposit slips and check books which she maintained (R. 2796-97). Surely they gave an "overall picture" of her dividends. Her doctor testified her charitable donations were related by her to dividends and market (R. 363).

Mrs. Hecht's failure to keep her monthly statements was due to her hiring Wilder to keep them for her. It was her bookkeeper and not Harris Upham's registered representative who deprived her of information. There is nothing in the record to suggest that if Mrs. Hecht had asked for her monthly statements she could not have obtained them, that she could not

have withheld them from Wilder in the first place, or that she did not know precisely what her dividend income was.

Plaintiff's argument is that the finding of waiver by the court below was clearly erroneous. Surely the court's finding of fact is sufficiently supported by evidence to make the claim without merit.

Waiver With Respect to Commodities (p. 41 of plff.'s brief):

The court found that Mrs. Hecht knew that she was actively speculating in commodities and that her knowledge of commodities was virtually "nil". The two statements are not inconsistent and probably describe most people who speculate in commodities. They are aware of the risk and the cost, but do not necessarily know very much about the many factors which affect demand, supply and price. Mrs. Hecht testified that she was repeatedly advised of the risk in commodities and urged to stay out.

There are many criticisms in plaintiff's brief of the commodities monthly statements furnished by the defendants, but no claim that they are different from those of any other broker or the requirements of any exchange. The brief assumes such information was unavailable to Mrs. Hecht. The assumption is not supported by the record. Monthly statements only tell the positions held, the positions taken or closed out during the month and the cash in the account. Market prices or the net position in the account would be more misleading than helpful because of the time lapse. An accurate appraisal of an account requires immediate information of market prices. These are

obtained from a broker by telephone, or from news media such as the Wall Street Journal, and Mrs. Hecht no doubt had such precise information. Her complaint at the trial was not that she did not know her position, only that she did not know where soybeans came from and that she did not understand some abbreviations (R. 2452).

Plaintiff does not criticize the closeout statements sent to her as being ambiguous or unrevealing. The closeout statements (an example of which is set forth in addendum) are clear and final in every respect. They state profit, loss and commissions. Since commodity positions are not held very long a trader in commodities knows her profits, losses and commissions soon enough and can decide whether or not to continue. In a context not blinded by sympathy for an elderly lady's losses, it is perfectly plain that the "badlands of commodities" are well advertised, and the virtues and faults of commodity trading were obvious to Mrs. Hecht before she became a customer of Harris Upham and brought with her a substantial commodity account.

In any event, does not the Statute of Limitations apply to such losses?

Mrs. Hecht's Damages With Respect to "Short Sales" and the "Failure to Manage Her Account as an Investment Account" (p. 43 of plff.'s brief):

The court below found plaintiff waived her claim in these respects. We have previously pointed out there was no loss from short sales or the failure to handle her account as an investment account.

Plaintiff quotes from *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 A.C.A. 759, 799 (1968). The court there stated that the question of knowledge and acquiescence in a trading account was one of fact for the trial court. It assumed if a plaintiff had knowledge her account was being traded she would be required to disaffirm or be bound by her failure to do so.

We suggest the issue is an academic one for whether or not plaintiff knew of her right to disaffirm she certainly knew of her right to discontinue. Her continuance is clear proof of her intention to ratify. It is her knowing satisfaction with the manner in which her account was handled which effectively constitutes a waiver on her part. Such satisfaction was a necessary inference because she admitted she knew in 1957 that her instructions were being violated and her account not being handled as she originally intended.

II

PLAINTIFF'S CLAIMS AS TO THE MEASURE OF DAMAGE AND RIGHT TO DAMAGES (p. 45 of plff.'s brief)

The Measure of Damage to be Applied:

The court found plaintiff made money in trading securities and lost money in trading commodities; the net difference is \$11,237 (T. 1014). Plaintiff insists and the court below acceded at least in part to the idea that the commodities and securities accounts should be treated as one. It would follow from plaintiff's own logic that she would be made whole by an award of \$11,237.

Plaintiff's argument is that her account should be judged by comparing actual management with proper management, although no proof was offered as to the results of "proper management of a trading account." She therefore asked the court to assume that she did not accede to a trading account, even if she did. If effect be given to the court's finding that she so acceded then surely the plaintiff is not entitled to such damage. It is impossible to measure damages by what would have happened if a trading account were differently traded. It would in effect be saying: "If she had kept the securities which have gone up and had sold the securities which went down before they went down. . . ."

To give the plaintiff the difference between a properly managed account and her account as managed, it would be necessary to establish, first, that the trading was unsuccessful, and that churning was the cause of its lack of success. In this case the securities account was successful. There is no proof that the extent of its trading increased or decreased its success. The loss in the commodity account was due to the DeAngelis scandal (see our principal brief). Certainly there was no "churning".

No federal decision supports the view that a court should speculate on how Mrs. Hecht would have come out if her account had been traded or managed differently. They are to the contrary.

See *Newkirk v. Hayden, Stone & Co.*, CCH Fed. Sec. L. Rep. ¶ 91621 (S.D. Cal. 1965);

Stevens v. Abbott, Proctor & Paine, CCH Fed.

Sec. L. Rep. ¶ 92257 (E.D. Va. 1968);

and cases cited in our principal brief.

A student article in the Harvard Law Review upon which plaintiff relies suggests possible theories of damage. It cites no authority and assumes churning deals with an account in which the customer left its character and management to her broker and knew nothing about it. Presumably, fraud is also assumed when damages are claimed. It does not purport to relate to an account where the customer agreed to a trading account and only looked to her broker for suggestions.

Twomey v. Mitchum, Jones & Templeton, Inc., supra, on which plaintiff relies, assumed the broker was in complete control of the character of the account and occupied a position of trust. It held the account management breached its trust and that churning was but an example of such breach. It distinguished damages for churning alone from damages for breach of trust in management generally. Even then it awarded only the difference between the original value and the value at the time of the account's withdrawal. It did not project the original account into the present, and fix present values.

It would not be appropriate to consider how plaintiff's account would have fared as an investment account if no securities had been sold.⁹ Plaintiff's securities were being purchased and sold at the time the

⁹Contrary to plaintiff's brief, the NASD does not hold this view (R. 3271-77).

account came to Harris Upham. The portfolio at that given moment was not a fixed portfolio; it was a trading portfolio in constant transition. Concern with how that particular portfolio would have fared seven years later is arbitrary even if plaintiff had not knowingly withdrawn moneys from the account for various purposes, including the trading of commodities (R. 2405; Exs. 95, 96).

The "Measure of Damages Applicable to a Breach of Fiduciary Duty" (p. 51 of plff.'s brief):

The Fiduciary

Our principal brief demonstrated that the "fiduciary duty" of a broker is fixed by the extent and character of his entrustment. See Point VIII.

SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

The cases cited by plaintiff are in agreement.

Cox v. Schnerr, 172 Cal. 371 (1916);

Gerhardt v. Weiss, 247 Cal.App.2d 114, 55 Cal. Rptr. 425 (1966);

Odorizzi v. Bloomfield School Dist., 246 Cal. App.2d 123, 129, 54 Cal. Rptr. 533 (1966).

One who repudiates his trust or is no longer trusted is no longer a fiduciary.

Abrams v. Bendat, 165 Cal.App.2d 89, 95, 331 P.2d 657, 660 (1958) and cases there cited.

A broker is obliged to execute orders honestly and favor his customer over himself in such execution. He is not permitted to engage in secret activity in conflict with the interest of his customer. He is not

automatically a trustee charged with the proper management of an account.

Neither California law nor any other law requires a broker, not an investment adviser, because he is a "fiduciary", to invest his client's money in any stated way except when he undertakes that obligation. The extent of Wilder's obligation related to his recommendation of the purchase of particular securities. In no other phase of his relationship with plaintiff did the court find control or confidence. There is no finding and nothing in the record to suggest that these recommendations were not in order.

The Damages

Damages arising from a breach of fiduciary duty are those which are proximately caused by the duty breached. *Cf.* California Civil Code, §3333. A fiduciary relationship and actual trust may prevent a person defrauded from discovering the fraud sooner or excuse his need to investigate in certain circumstances and thereby result in additional damage as it did in *Walsh v. Hooker & Fay*, 212 Cal. App. 2d 450, 461, 28 Cal. Rptr. 16 (1963), but the requirement of proximate cause remains the same. A fiduciary is required to return secret profits, or moneys made in violation of his trust or without its contemplation, but he is not required to return moneys made with the consent and knowledge of his principal. In *Estate of Talbot*, 141 Cal. App. 2d 309, 296 P.2d 848 (1956) cited by plaintiff, the court stated a trustee is required to pay the income from property diverted during the

period of diversion, but only if he had no right to sell and made sales without his beneficiary's knowledge. The principle for which plaintiff argues does not apply to a trading account in commodities or securities to which plaintiff acceded with full knowledge that trading in commodities costs money, that losses may result, and that money used in trading commodities or lost in such trading cannot also earn income.

III

PLAINTIFF'S "UNCOMPENSATED" DAMAGES

(p. 52 of plff.'s brief)

Plaintiff contends she is entitled to be compensated for taxes paid. She relies on *Stevens v. Abbott, Proctor & Paine*, supra. Unlike Mrs. Stevens, Mrs. Hecht knew she was actively trading securities for gain as she had in the thirties and immediately before she came to Harris Upham. Mrs. Hecht was well aware of the fact that capital gains taxes are a necessary concomitant of making profit. She reviewed her tax returns. She is not entitled to charge these payments to Harris Upham. Neither is she entitled to claim transfer taxes.

Plaintiff claims a loss of growth in the value of her account due to the churning of her account. There is no evidence of that. The *Stevens* case regarded such claims as speculative, and nothing in the record changes that conclusion.

IV

DAMAGES UNDER CALIFORNIA LAW
AND FOR "BREACH OF TRUST"**Pendant Jurisdiction:**

It would seem unnecessary to deal with plaintiff's contentions regarding "pendant jurisdiction", for as we have demonstrated in Point II of our principal brief California law does not help plaintiff; it does not create fiduciary relationships where none exist. We nevertheless discuss it briefly.

Plaintiff would append to an action for excessive trading an action for "breach of trust." As this court has stated, such an assumption of pendant jurisdiction "would be making the tail wag the dog."

Moynehan v. Pari-Mutuel Employees Guild,
317 F.2d 209, 212 (9 Cir. 1963), *cert. denied*,
375 U.S. 911.

A "breach of trust" may subsume excessive trading; but excessive trading does not encompass all "breaches of trust." See cases cited in Point II-A of our principal brief. Federal jurisdiction so broadly assumed would effectively deprive state courts of much of their traditional jurisdiction in the supervision of trusts which own securities. If plaintiff intended trust relief, as her complaint stated, the state courts were available to her. She should have brought her action there and should not have opposed our motion to dismiss for lack of jurisdiction.

Gully v. First Nat'l Bank, 299 U.S. 109, 115
(1936).

Plaintiff is attempting to broaden the Securities Exchange Act to all manner of broker-customer relationships. The law is to the contrary. See Point I-D of our principal brief.

V

**DAMAGES AND THE "SUITABILITY" OF
PLAINTIFF'S ACCOUNT (p. 59, plff.'s brief)**

There was no evidence or finding of "unsuitability". No damage resulting from unsuitability was proved; nor is there any evidence that a more suitable handling of the account would have been more profitable. The court below also found that any claim under the suitability rule of the National Association of Securities Dealers was barred to plaintiff by her estoppel, waiver and laches, because she knew her account was unsuitable to her "needs and circumstances".

"Suitability" of particular purchases is provided for in Rule 2 of the National Association of Securities Dealers rules. Section 27 of the Securities Exchange Act provides for relief for violation of the Act, not for violation of National Association of Securities Dealers rules. If the rules are to be incorporated they would derive their authority from Section 15 of the Act which contemplates a national association concerned with over-the-counter securities. Rule 2 of the Association is limited to over-the-counter securities (R. 3294). The court did not find Mrs. Hecht's over-the-counter purchases were "unsuitable".

Plaintiff's brief makes much of the importance of a private right of action under Rule 10 b-5, but "suitability" has not been incorporated by the Securities and Exchange Commission into 10 b-5. See our principal brief, Point I-D and E. As the court below recognized, National Association of Securities Dealers rules which do not prohibit fraudulent conduct are not enforceable in federal courts.

Colonial Realty Co. v. Bache & Co., 358 F.2d 178 (2 Cir. 1966).

Plaintiff seeks to distinguish the *Bache & Co.* case because it did not bar all Rules of the National Association of Securities Dealers from federal enforcement. She ignores the fact that the court considered only fraud as federally enforceable.

Plaintiff cites *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boccock*, 247 F. Supp. 373 (S.D. Tex. 1965) where the court taxed a broker for the manner in which a trust account was handled by a trustee. In that case Merrill Lynch was on notice of the limitations of the trust account, and because of such notice was held liable for the unauthorized conduct of the trustee. The trustee's personal action, that his account was "churned", was dismissed.

Plaintiff claims the "suitability" rule is sufficiently definite to serve as a basis for disciplinary action by the Commission without "second guessing" as to market judgment. The Securities and Exchange Commission has expertise and does not award damages; no expert appeared on behalf of the plaintiff to establish the unsuitability of the account generally, or the

damage. (See our fact analysis, *supra*). The “unsuitability” of plaintiff’s account in the month of March 1964 as an investment account—not as a trading account—proves nothing, except with respect to the account in March 1964.

All of the foregoing is, however, academic because if a violation of a National Association of Securities Dealers rule constituted a “fraud” under Section 15(c)(1) of the Securities Exchange Act which deals with over-the-counter transactions, then surely Section 29(b) would apply to bar plaintiff’s action. Her action, as we have previously pointed out, was brought more than one year after, by her own admission (complaint, par. 17) she knew all the facts.

Goldenberg v. Bache & Co., 270 F.2d 675 (5 Cir. 1959).

Parenthetically, since the court below did not find fraud as that is commonly understood, or nondisclosure of “unsuitability”, did not the Statute of Limitations with respect to defendant’s claimed “improprieties” begin to run from the day they occurred?

VI

PUNITIVE DAMAGES (p. 67 of plff.’s brief)

The following cases have rejected punitive damages, in an action under the Securities Exchange Act:

Stevens v. Abbott, Proctor & Paine, CCH Fed.

Sec. L. Rep. ¶ 92257 (E.D. Va. 1968);

Globus v. Law Research Serv., Inc., CCH Fed.

Sec. L. Rep. ¶ 92226 (S.D.N.Y. 1968);

Pappas v. Moss, 257 F. Supp. 345 (D. N.J. 1966);

Meisel v. North Jersey Trust Co., 218 F. Supp. 274 (S.D.N.Y. 1963).

In the *Globus* case, the court stated it could allow penal damages under the Securities Act of 1933 in the case of "wanton dishonesty, high moral culpability and a gross fraud aimed at the public generally", but could not allow such damages under the Securities Exchange Act. It cited the *Meisel* and *Pappas* cases. The *Stevens* case regarded additional payment to plaintiff as not serving the public interest. In the instant case there is no proof or finding of wanton dishonesty, high moral culpability or a gross fraud aimed at the public generally by Harris Upham, only a finding of failure adequately to supervise.

Section 17(a) of the Securities Act is not applicable here. It does not apply to a broker acting as his customer's agent (R. 623-29, 709); it applies to a "dealer" who sells to his customers from his own inventory (see our addendum).

The state law rule with respect to punitive damages requires oppression or malice on the part of the principal. Malice on the part of an agent is not sufficient unless specifically authorized by the principal.

Security-First Nat'l Bank v. Lutz, 297 F.2d 159, 164-65 (9 Cir. 1961);

Wolfson v. Hathaway, 32 Cal.2d 632, 647-48,
198 P.2d 1, 11 (1948);
Gombos v. Ashe, 158 Cal.App.2d 517, 526-27,
322 P.2d 933, 939 (1958).

There is no proof in this case of malice on the part of anyone.

Plaintiff's Motion With Respect to Punitive Damages:

Plaintiff maintains she should have had an opportunity to offer additional evidence with respect to Harris Upham's supervision. She fails to recognize that supervision is a basis for vicarious liability, not for direct liability under Section 10(b). Since lack of supervision is not an offense, it cannot be the basis for punitive damages.

For additional reasons why plaintiff's motion should be denied, we respectfully call the Court's attention to the Memorandum of Decision of the Court below denying plaintiff's motion for leave to reopen the case (Appendix B, pp. 34 et seq. of plaintiff's brief).

CONCLUSION

Plaintiff's appeal should be dismissed and costs and disbursements awarded defendants.

Dated, San Francisco, California,
December 30, 1968.

Respectfully submitted,
EMANUEL BECKER,
THOMAS A. H. HARTWELL,
COOLEY, CROWLEY, GAITHER, GODWARD,
CASTRO & HUDDLESON,
Attorneys for Defendants
Harris, Upham & Co., et ano.

(Addendum Follows)



Addendum



Billhead of
HOOKER & FAY
221 Montgomery Street
San Francisco 4

Date 5/3/57

ement of Purchase and Sale of
May Soybean Oil—Chgo.
the Account and Risk of Mrs. Bertha Hecht

| <u>Bought</u> | | | | <u>Sold</u> | | | |
|---------------|----------|-------------------|-----------|-------------|----------|----------------|-----------|
| | Quantity | Price | Amount | Date | Quantity | Price | Amount |
| 57 | 1 CAK | 1308 | 7,848.00 | | | | |
| 56 | 2 CAK | 1338 | 16,056.00 | 5/3/57 | 3 CAK | 1191 | 21,438.00 |
| | | Total | 23,904.00 | | | Total | 21,438.00 |
| \$ | 2466.00 | Commission Tax | 90.00 | Gain..... | | | |
| | | To Your Debit | 2556.00 | | | To Your Credit | |

Errors and Omissions Excepted

SECURITIES EXCHANGE ACT PROVISIONS**Regulation of the Use of Manipulative and Deceptive Devices**

SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SECTION 15(c)(1) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

Liabilities of Controlling Persons

SECTION 20. (a) Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation there-

under shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Jurisdiction of Offenses and Suits

SECTION 27. The district courts of the United States, the United States District Court for the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347). No costs shall be assessed for or against the Commission in any proceeding under this title brought

by or against it in the Supreme Court or such other courts.

Effect on Existing Law

SECTION 28. (a) The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder.

Validity of Contracts

SECTION 29. (a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.

(b) Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title

or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation: *Provided*, (A) That no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (2) or (3) of subsection (c) of section 15 of this title, and (B) that no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of section 15 of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation.

**RULES OF THE SECURITIES AND EXCHANGE COMMISSION
PURSUANT TO THE SECURITIES EXCHANGE ACT.**

Rule 10b-3. Employment of Manipulative and Deceptive Devices

It shall be unlawful for any broker or dealer, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any security otherwise than on a national securities exchange, any act, practice, or course of business defined by the Commission to be included within the term "manipulative, deceptive, or other fraudulent device or contrivance," as such term is used in section 15(c)(1) of the Act.

Rule 10b-5. Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Rule 15c 1-7. Discretionary Accounts

(a) The term “manipulative, deceptive or other fraudulent device or contrivance,” as used in section 15(c)(1) of the Act, is hereby defined to include any act of any broker or dealer designed to effect with or for any customer’s account in respect to which such broker or dealer or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

(b) The term “manipulative, deceptive, or other fraudulent device or contrivance,” as used in section 15(c)(1) of the Act, is hereby defined to include any act of any broker or dealer designed to effect with or for any customer’s account in respect to which such broker or dealer or his agent or employee is vested with any discretionary power any transaction of purchase or sale unless immediately after effecting such transaction such broker or dealer makes a record of such transaction which record includes the name of such customer, the name, amount, and price of the security, and the date and time when such transaction took place.

SECURITIES ACT OF 1933

Sec. 2. When used in this title, unless the context otherwise requires—

(3) The term “sale” or “sell” shall include every contract of sale or disposition of a security or interest in a security, for value. The term “offer to sell”, “offer for sale”, or “offer” shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.

Sec. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Nos. 22,971, 23,017

FEB 21 1969

In the
United States Court of Appeals
For the Ninth Circuit

BERTHA HECHT,

Plaintiff-Appellee-Appellant,

vs.

HARRIS, UPHAM & Co., a partnership,

HARRIS, UPHAM & Co., INC., a corporation,

Defendants-Appellants-Appellees.

Opening Brief of Bertha Hecht

DONALD F. X. FINN

63 Wall Street

New York, New York

REED H. BEMENT

MORRIS LOWENTHAL

LOWENTHAL & LOWENTHAL

405 Montgomery Street

San Francisco, California 94104

Tel. No. 986-5388

Attorneys for Bertha Hecht

FILED

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WM. B. LUCK, CLERK

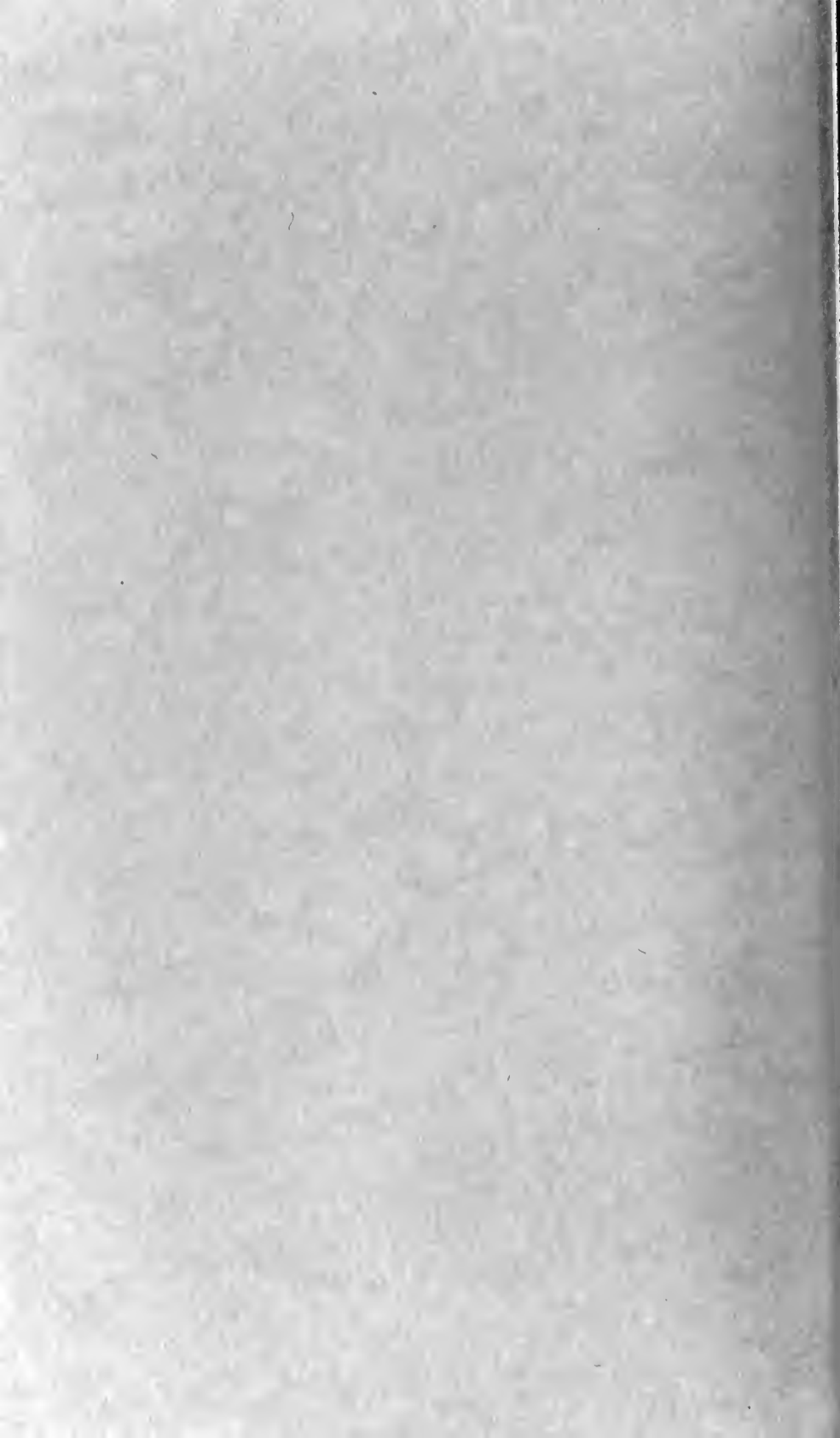


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Nos. 22971 and 23017

In the
United States Court of Appeals
For the Ninth Circuit

| | |
|--------------------------------------|---|
| BERTHA HECHT, | } |
| <i>Plaintiff-Appellee-Appellant,</i> | |
| vs. | |

| | |
|--|---|
| HARRIS, UPHAM & Co., a partnership, HARRIS, UPHAM & Co., INC., a corporation, | } |
| <i>Defendants-Appellants-Appellees.</i> | |

Opening Brief of Bertha Hecht

PRELIMINARY STATEMENT

Cross appeals pursuant to 28 U.S.C. Sections 1291 and 1294(1) have been filed by Harris, Upham & Co. and Harris, Upham & Co., Inc. (No. 22971) and by Mrs. Bertha Hecht (No. 23017) from the judgment of the District Court for the Northern District of California entered on March 29, 1968 in favor of Bertha Hecht in the amount of \$504,391.02. This Court ordered these appeals consolidated on October 9, 1968.

The District Court's Opinion (Sweigert, J.) is reported at 283 F.Supp. 417.¹

1. Mrs. Hecht will be referred to herein by name or as plaintiff. "C.T." page references herein are to pages in the Clerk's Transcript on file herein in five volumes. "R.T." page references herein are to pages in the Reporter's Trial Transcript on file herein in twenty-nine volumes.

Plaintiff's appeal presents for review the question of whether the defenses of estoppel, waiver and laches can properly be applied to bar her from recovering damages resulting from defendants' failure to properly manage her account as an investment account.

This appeal raises other issues related to the trial court's denial of damages based upon the proper investment management of plaintiff's account and issues involving the trial court's denial of punitive damages.

Finally, whether there is an implied right of private action for a violation of the suitability rule of the National Association of Securities Dealers, Inc., as plaintiff contends, is raised for the first time in a Circuit Court of Appeals.

STATEMENT OF THE CASE

Nature of the Case

Plaintiff Bertha Hecht, a widow now 77 years of age and a resident of San Mateo, California, instituted this action on September 20, 1965 as a former customer against Harris, Upham & Co. and Harris, Upham & Co., Inc.² (hereafter referred to as Harris, Upham & Co.), a broker-dealer in securities and commodities, Asa V. Wilder, its Registered Representative and Commodities Manager of its Northern California offices, Arthur R. Mejia, its San Francisco Resident Partner and Branch Manager, and against the principal executive and supervisory partners of Harris, Upham & Co., to recover \$1,109,000 compensatory plus punitive damages arising from the defendants' fraudulent handling of her account and their breach of fiduciary duties.

Plaintiff claims that defendants' conduct violated:

2. Harris, Upham & Co. changed from a partnership to a corporation on September 1, 1965 (R.T. 171). The defendants in the District Court will be referred to herein by name or as defendants.

1. The anti-fraud provisions of the Federal Securities Laws;³
2. The Commodities Exchange Act;⁴
3. The Rules of Fair Practice of the National Association of Securities Dealers, Inc. (hereafter "NASD");⁵
4. Rules 401, 405 and 408 of the Rules of the New York Stock Exchange;⁶
5. Rules 146 and 151 and Regulations 1820 and 1820-A of the Board of Trade of the City of Chicago; and
6. The common law of California regarding breaches of fiduciary duties and obligations.⁷

Course and Disposition of Proceedings Below

After a 27 day trial without a jury (all parties having waived a jury) and several days of extended argument, a Memorandum of Decision in favor of plaintiff was rendered and a judgment entered thereon in the amount of \$504,391.02 against Harris, Upham & Co., Harris, Upham & Co., Inc. and Mr. Wilder (C.T. 1060-1061).

3. Securities Act of 1933, Section 17(a) (15 U.S.C.A. § 77q(a)). Securities Exchange Act of 1934, Section 10(b) (15 U.S.C.A. § 78j(b)) and Rule 10b-5 (17 C.F.R. § 240.10b-5) promulgated thereunder. See Alan Bromberg, *Securities Law: Fraud-SEC Rule 10b-5* (McGraw-Hill 1967); Note, *Rule 10b-5: Elements of a Private Right of Action*, 43 N.Y.U.L. Rev. 541 (1968). Securities Exchange Act of 1934, Section 29 (b) (15 U.S.C.A. § 78cc(b)).

4. Sections 4b and 9 (7 U.S.C.A. §§ 6b, 13). See *Goodman v. H. Hentz & Co.*, 265 F.Supp. 440 (N.D. Ill. 1967).

5. Article III, Sections 1, 2, 15, 18, 19 and 27 (Plaintiff's Exhibit 295); Lowenfels, *Private Enforcement in the Over-the-Counter Securities Market: Implied Liabilities Based on NASD Rules*, 51 Cornell L.Q. 633 (1966).

6. Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 Columbia L. Rev. 12 (1966).

7. *Twomey v. Mitchum, Jones & Templeton*, 262 A.C.A. 759 (1968); *Blackburn v. Dean Witter & Co.*, 201 Cal.App.2d 518 (1962); *Gaver v. Early*, 58 Cal.App. 736, 737 (1923); *Walsh v. Hooker & Fay*, 212 Cal. App.2d 450, 454 (1963); *Kinert v. Wright*, 81 Cal.App.2d 919, 925 (1947); Plaintiff's Trial Memorandum of Law (C.T. 558-561).

The District Court held these defendants defrauded plaintiff by having "clearly and unfairly" mishandled her account "as a fiduciary" (283 F.Supp. at 440), and by having "grossly and unfairly churned her account", that is, by engaging in securities and commodities transactions which were excessive in view of the character of plaintiff's account and her investment needs and objectives and without justification other than to profit themselves.⁸ 283 F. Supp. at 436.

The churning of plaintiff's account was held to violate Section 10b of the Securities Exchange Act (15 U.S.C. § 78j(b)) and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission (17 C.F.R. § 240.10b-5).

Fraud was also found in connection with two specific security transactions (the *Itek* and *Colonial* transactions) in which Mr. Wilder procured stock certificates from plaintiff with no payment in one instance and only partial payment in the other and without plaintiff's informed understanding or knowledge. 283 F. Supp. at 442-443.

Further, the trial court held:

" . . . that defendant Harris, Upham did not maintain a reasonably adequate system of internal supervision and control; that it did not enforce with any reasonable diligence

8. Between May 1957 and March 1964, Harris, Upham & Co. charged plaintiff \$232,000 in commissions and interest while effecting over 10,000 transactions involving 200 different securities and 16 different commodity futures, having a gross purchase and sale value of \$98,000,000. From an initial value of \$533,161, the account declined to a value of \$251,308 in March 1964. The District Court found that:

"It can be calculated that, if the original portfolio transferred to Harris, Upham in May 1957, had been maintained intact during the period 1957-1964 (a period of general rise in securities values) it would have had a net value by March, 1964, of about \$1,026,775 instead of \$251,308.

"It can also be calculated that, if the original portfolio of the securities delivered to Harris, Upham Co., in May, 1957, had been maintained intact the account would have yielded by March, 1964, dividends and bond interest in the amount of about \$194,135 instead of \$124,237." 283 F.Supp. at 424-425.

such system as it did maintain and that in this respect defendant Harris, Upham cannot be said to have acted in good faith within the meaning of Section 20(a) of the Securities Exchange Act (15 U.S.C. § 78t(a)) but did, on the contrary, indirectly induce, participate in, approve and accept the benefits of what we have found to be the excessive trading of the account . . . " 283 F. Supp. at 439.

"The Court finds and concludes from the evidence that, with respect to the Itek and Colonial transactions, Wilder was acting in the course of his employment for Harris, Upham and that his conduct in such transactions must be deemed to be the conduct of Harris, Upham. Further, the Court finds that in these transactions Harris, Upham failed to comply with the requirement for internal supervision as provided by Section 20(a) of the Securities Exchange Act (15 U.S.C. § 78t(a))." 283 F. Supp. at 443.

Damages were awarded plaintiff as follows (283 F. Supp. at 440, 444):

Actual damages due to churning:

| | | |
|--|-----------|-----------|
| Commissions and interest paid by plaintiff | \$232,000 | |
| Additional Commodity Losses | 78,000 | |
| Loss of Dividend income | 65,000 | |
| | <hr/> | \$375,000 |

Actual damages due to Itek and Colonial Transactions:

| | | |
|----------------|--------|-----------|
| Itek | 20,600 | |
| Colonial | 43,920 | 64,520 |
| | <hr/> | <hr/> |
| | | \$439,520 |

Interest at the rate of seven per cent (7%) per annum was awarded on the amount of \$232,000 (interest and commissions paid by plaintiff) from April 1, 1964 to the date of judgment herein (March 29, 1968), a sum of \$64,871.02 (C.T. 1061).

A Notice of Appeal was filed by Harris, Upham & Co. and Harris, Upham & Co., Inc. on April 8, 1968 (C.T. 1063).

Plaintiff filed a Notice of Appeal on April 25, 1968 (C.T. 1069).

Defendant Wilder did not appeal from the judgment.

Following a hearing conducted in March 1968, the NASD found that defendants improperly managed Mrs. Hecht's account as a whole and misused and unsuitably used her funds by churning her account. It further found that Harris, Upham & Co. failed in its duty to exercise proper and adequate supervision over its San Francisco branch manager (Arthur R. Mejia), its San Francisco Commodity Manager (Asa V. Wilder), and plaintiff's account; and that Mr. Mejia failed to exercise proper and adequate supervision over Mr. Wilder, as was his duty. *Hecht v. Harris, Upham & Co., et al* NASD Decision, Complaint No. A-298 (August 29, 1968). Appeals to the NASD Board of Governors from this Decision have been instituted. This decision is printed herewith as Appendix A and incorporated herein by reference. It is presented in this manner for the convenience of this Court and because of its bearing, inter alia, on the District Court's ruling on the issue of punitive damages and Mrs. Hecht's right to recover a full measure of compensatory damages for violation of NASD rules, *infra* pp. 67-73.

STATEMENT OF THE FACTS

A. The Parties

Plaintiff:

Mrs. Bertha Hecht was born in Liverpool, England, on November 20, 1890 (R.T. 2273-2274). After completing her elementary education, she studied as a student nurse but withdrew after failing her medical board examination. She then attended a teachers college for two years and thereafter taught elementary school in England. (R.T. 2274-2275) In 1913 she moved to Canada and then to the United States. About 1923, after the death of her mother, she settled in the San Francisco area (R.T. 2274) and in 1933 became a United States citizen (R.T. 2441).

She was employed as a department store saleslady (R.T. 2281), as a children's tutor (R.T. 2278, 2284) and as a housekeeper (R.T. 2282) prior to 1939, when she became a member of the household of Mr. Herbert Hecht of San Mateo, California, to care for Mr. Hecht's home and bring up his young daughter, whose mother had recently died (R.T. 2284-2285). In January 1953, Mr. and Mrs. Hecht were married (R.T. 2394). Mr. Hecht handled Mrs. Hecht's financial affairs (R.T. 2447:14-23) and borrowed money from her savings to purchase their home and for use in his business (R.T. 2424-2425, 2448, 2548-2551).

Mr. Hecht died suddenly of a heart attack in January 1955, when Mrs. Hecht was 64 years old (R.T. 2287). Since then Mrs. Hecht has lived alone in San Mateo. Mr. Hecht left a substantial estate which was divided equally between Mrs. Hecht and her step-daughter Nancy (R.T. 143). This inheritance (consisting primarily of blue chip securities) and her own securities and savings have ever since been Mrs. Hecht's sole means of support. She lives frugally but is a charitable woman (R.T. 315, 1088, 2440; Mahoney Exhibits 1-3; Defendants' Exhibits H 14-17).⁹

Mrs. Hecht has a history of frequent hospitalizations and has suffered from a series of debilitating physical and mental illnesses which have seriously impaired her ability to function properly and to comprehend her situation (R.T. 305:22-25; Plaintiff's Exhibits 213-215; C.T. 254:3-18, 368:9-12¹⁰). The District Court described her as "an unstable, erratic and commercially unsophisticated woman." 283 F. Supp. at 433.

After Mr. Hecht's sudden death in January 1955, Mrs. Hecht became distraught, bewildered and dazed and was taken by Mr. Wilder into his home (R.T. 1214-1216, 2600-2602). In May

9. Exhibit references herein are to the exhibits introduced during the trial and now before this Court.

10. Citations to C.T. 250 to 254 and 368 refer to facts admitted by defendants during pre-trial and identified in the pre-trial Order (C.T. 362-385).

1955, Mrs. Hecht suffered an acute brain syndrome caused by a cerebral infarction (Plaintiff's Exhibit 187-1; R.T. 752) and was hospitalized suffering from delusions and hallucinations (R.T. 751, 769, 774; Plaintiff's Exhibit 213).

In October and November 1955, Mrs. Hecht became severely depressed, confused and incoherent and was confined to a sanitarium and received a number of shock treatments. At that time her psychiatrist found her judgment was poor and concluded that she was a "borderline" incompetent. (R.T. 752, 785-786, 792-794, 798, 800, 807, 2293-2294)

Since May 1955 Mrs. Hecht has suffered from underlying limitations due to the resulting organic brain damage (R.T. 800) and has schizophrenic traits (R.T. 314:14-18). Both in 1955 and in recent years, brain wave tests of Mrs. Hecht have revealed an abnormality probably resulting from organic brain damage or arteriosclerosis (R.T. 308-311, 799-800; Plaintiff's Exhibit 187-3).

In March 1963 Mrs. Hecht was hospitalized for knee surgery and was observed to be very nervous and apprehensive. She refused to stay in the hospital after the operation even though advised to do so by her doctor. The following day she was again hospitalized and was diagnosed as suffering from a toxic psychosis (a form of dementia) resulting in extreme disorientation and confusion. (R.T. 370-373, 307, 347-349; Plaintiff's Exhibits 214, 215)

Mrs. Hecht has a dependent and passive temperament which has limited her ability to raise outward objections to what are really unpleasant or uneasy situations for her (R.T. 312-315, 365-366, 2928).

Mrs. Hecht is described by those who know her best (her doctor, accountants and investment advisor) as "disorganized," "forgetful" (R.T. 317, 324:2-9, 810:23-811:2, 3411-3413) and "rambling" (R.T. 1798:15-17), as a person who becomes "easily confused" (R.T. 1806:22-25) and "finds it difficult to pursue a course" (R.T. 364:1-4), as one who is not a "business woman"

(R.T. 1887:25) and who is "totally incapable of managing her affairs from a financial standpoint" (R.T. 1898:16-18).

Mrs. Hecht does not understand many of the important terms used in the securities industry and was unable to understand the monthly account statements and purchase and sales confirmations sent to her by Harris, Upham & Co. relating to her account (R.T. 1702:12-17, 2908-2919, 2862, 2488-2490, 2868, 2525, 2852, 2944, 2967, 3037). Although Mr. Wilder attempted to have Mrs. Hecht, rather than her accountants, keep ledger sheets on her securities, she was incapable of doing so satisfactorily and Mr. Wilder took her books away from her and assumed the responsibility of keeping them himself (R.T. 2390-2391, 2707). Mr. William P. Wentworth, her financial advisor since April 1964, testified that Mrs. Hecht is completely unaware of the true status of her financial affairs and that she has no knowledge or understanding of the merits of particular securities (R.T. 1899-1900).

In short, during the time period here in question, Mrs. Hecht was not capable of exercising any continuous and intelligent judgment concerning her business affairs and was not knowledgeable regarding securities and commodities transactions. That Mrs. Hecht lacked such judgment and was easily taken advantage of by others is abundantly confirmed not only by the facts revealed by this litigation, but also by the fact that she was induced in 1957, at the age of 67, to purchase some \$26,000 worth of dance lessons (R.T. 999-1000; Plaintiff's Exhibit 201).

For further details of plaintiff's health, personality and business capabilities with supporting citations to the record, see Plaintiff's Trial Memorandum of Fact (C.T. 577-585).

Defendants:

Harris, Upham & Co. is a registered broker and dealer in securities and commodity futures with 63 branch offices in 54 American cities and Geneva, Switzerland. Founded in 1895, it has grown from a Chicago based commodities operation to one of the largest

warehouse or commission operations in the United States (George U. Harris Deposition,¹¹ 4-7). It services 300,000 customers including some 66,000 active accounts and grosses over twenty million dollars annually (George U. Harris Deposition, 7-10). It has over 1,400 employees, including over 600 registered representatives (Plaintiff's Exhibit 5). Its stated gross assets are \$135 million (Plaintiff's Exhibit 321).

Harris, Upham & Co.'s principal executive and administrative office is in New York City. Between 1954 and 1965, the senior management of the firm consisted of its two "Directing Partners", Mr. George Upham Harris, and Mr. Henry Upham Harris, Sr. (Smith Deposition,¹¹ 21; R.T. 180-182).

The Commodities Department of Harris, Upham & Co. has been under the direction of George Upham Harris since 1957 and even before (R.T. 180; C.T. 252:16-18, 368:9).

Since September 1, 1965, the Chairman of the Board of Harris, Upham & Co., Inc. has been George Upham Harris; the President and Chief Executive Office has been Henry Upham Harris, Sr.; the Executive Vice-President has been Henry Upham Harris, Jr.; the Treasurer (Comptroller) has been Matthew Smith; the Senior Vice-President in charge of security regulation interpretation has been James F. Burns (Plaintiff's Exhibit 3B). These same individuals performed the same functions for the partnership from 1957 until the date of incorporation. (Surprisingly, no officer was specifically placed in charge of or made responsible for supervisory or compliance matters and these matters were left to local branch offices.)

Harris, Upham & Co. has been censured and fined \$50,000 by the NASD for violating its Rules of Fair Practice through failing to exercise proper and adequate supervision of its San Francisco branch office and Mr. Wilder's handling of Mrs. Hecht's account. See Appendix A attached hereto.

11. Admitted in evidence, R.T. 3636-3640.

Mr. Arthur R. Mejia has been in the stockbrokerage business since 1923. He has been the resident partner and supervisory officer in charge of Harris, Upham & Co.'s San Francisco branch office since its opening in 1951 (C.T. 252:12-15; 368:4; R.T. 171-172, 464, 491) and in this capacity was responsible for supervising Mr. Wilder and some twenty other registered representatives and their handling of approximately 8,000 to 9,000 accounts, including 900-1,200 active customers' securities accounts and 34-64 active commodities accounts (R.T. 404-405; Plaintiff's Exhibit 192-2 (35)).

Mr. Mejia is a member of the Pacific Coast Stock Exchange and a former member of the Chicago Board of Trade, the principal commodities exchange in the United States (R.T. 173-174; Plaintiff's Exhibit 192-1 (2e)).

Mr. Mejia was fined \$5,000 and had his registration as a broker suspended for five days by the NASD because of his failure to exercise proper and adequate supervision over Mr. Wilder and the handling of Mrs. Hecht's account.

Mr. Asa V. Wilder has been active in the securities and commodities field since World War I (C.T. 250:30-32, 368:4) and was employed by Harris, Upham & Co. on May 1, 1957 as a registered representative and as manager of the Commodities Department for Northern California. He was based in the San Francisco office and his duties included both the "sales and promotion of commodities" (R.T. 252, 545, 1014-1016; Plaintiff's Exhibits 133, 134) and the supervision of commodity transactions in the Northern California branch offices (R.T. 442-443; Plaintiff's Exhibit 192-1 (1h)).

Mr. Wilder previously had been a partner in a stock brokerage firm in San Francisco and for twenty-five years prior thereto was employed as a "commodity specialist" at Merrill Lynch, Pierce, Fenner and Beane, and predecessor firms (R. T. 1015). At the time of his employment by Harris, Upham & Co. he was a member of the Chicago Board of Trade (R.T. 2235-2236; C.T. 251:11-14, 368:4).

After the conclusion of the trial Mr. Wilder left the employ of Harris, Upham & Co. (R.T. 4748, statement of defendants' counsel) and has since defaulted in appearing at the disciplinary hearing conducted by the NASD in March 1968, and at the disciplinary hearing conducted by the Commodity Exchange Authority of the Department of Agriculture on September 17, 1968.

Mr. Wilder's registration as a broker was revoked by the NASD because of his improper actions involving Mrs. Hecht's account.

For further details on Mr. Wilder, see Plaintiff's Trial Memorandum of Fact (C.T. 588-589).

B. The Relationship Between Mr. Wilder and Mrs. Hecht

Mr. Wilder became plaintiff's "financial advisor" immediately following the death of her husband. He had complete charge and control of her investment affairs from 1955 until March 1964 and, therefore, occupied a position of trust and confidence calling for the exercise of the utmost good faith in all his dealings with plaintiff.

Mr. Wilder lived near Mrs. Hecht and took her into his home immediately following her husband's funeral in January 1955, when she was dazed and distraught (R.T. 1215, 2289-2290, 2600-2602). He arranged for an attorney to handle her interest in her late husband's estate (R.T. 2292, 2388). This attorney obtained Mr. Wilder's advice during the probate proceedings regarding the sale of securities for tax purposes and directed sales through him (R.T. 1257-1260, 1262-1265; Plaintiff's Exhibits 87, 89).

At this time Mr. Wilder assured Mrs. Hecht that he would look after and care for her, represented that there was plenty of money for her, and told her that she need not worry about her financial affairs (R.T. 2388-2389, 2620).

When Mr. Wilder took over the direction of plaintiff's financial affairs, he was able to obtain control over her personal investments by arranging for the transfer of a dormant securities account carried in her name at Walston & Co. (R.T. 2389-2390, 453-

1075). This inactive account had been controlled and handled since 1939 by Mr. Hecht and by Mr. Ernest Fairey, the registered representative in charge of Mrs. Hecht's account at Walston & Co. (R.T. 2433-2434, 2975).

It is clear that Mrs. Hecht was unaware of the transfer of this account at the time Mr. Wilder arranged for it and that at the time she was completely incapable of appreciating its significance (R.T. 2451, 2927).

When securities were distributed to Mrs. Hecht from her husband's estate in 1955 and 1956, they were sent directly to Mr. Wilder and became part of Mrs. Hecht's account (Plaintiff's Exhibits 154-159).

When Mr. Wilder became employed by Harris, Upham & Co. on May 1, 1957, he transferred Mrs. Hecht's account to that firm without her knowledge, and it remained there until March 1964. The details of defendants' improper conduct in opening the account are set forth in Plaintiff's Trial Memorandum of Fact (C.T. 600-608). During the seven-year period the account was at Harris, Upham & Co. there was no substantial disagreement between Mrs. Hecht and Mr. Wilder and she named him in wills as a legatee, referring to him as her "friend and financial advisor" (R.T. 1237:15-18; 988, 2413-2415; Mahoney Exhibits 1-3).

Of the approximately 1200-1400 securities transactions effected in Mrs. Hecht's account at Harris, Upham & Co. between May 1957 and March 1964, all but two or three were solicited and recommended by Mr. Wilder while, without exception, every one of the approximately 8,900 commodity transactions were initiated solely by Mr. Wilder (R.T. 1541-1542, 1658, 1436-1438).

Mr. Wilder admittedly exercised complete discretion in effecting transactions (that is, he did not even first solicit the transaction before effecting it) on the frequent occasions when Mrs. Hecht was away from her home on a trip or in the hospital (R.T. 1179-1184, 1142-1143, 1129). The exercise of such discretion violated the rules and regulations of the New York Stock Ex-

change, the Chicago Board of Trade (R.T. 2236), the NASD, and Harris, Upham & Co.'s own supervisory policy (Plaintiff's Exhibits 268, 297, 13).

Mr. Wilder called Mrs. Hecht daily and went to her home at least weekly and frequently more often and took from her—and to his own home—all the account statements and papers mailed to her by Harris, Upham & Co. (R.T. 1338, 1775, 2964). Mr. Wilder kept these at his home, although he had a duplicate copy available to him at his office desk (R.T. 1339, 1374-1375). They were given for short periods of time to the tax accountants (introduced to Mrs. Hecht by Mr. Wilder) who prepared her income tax returns (R.T. 1785-1786, 1792-1793). Mr. Wilder undertook to and did prepare summaries of the securities and commodities transactions for inclusion in the tax returns and it was from him that the accountants obtained all information regarding these transactions. (R.T. 1786-1787, 1790). At no time prior to March 1964 did the accountants discuss any matter with Mrs. Hecht regarding the transactions in her account at Harris, Upham & Co. as they had been led to understand that Mr. Wilder was her financial advisor and stockbroker and that it was his business to discuss her investment affairs with her. (R.T. 1789-1792, 2867-2868; Plaintiff's Exhibits 20C1-5, 20D1-9)

Mr. Wilder prepared checks for Mrs. Hecht's signature to cover the payment of county, city, state and federal taxes and for deposits into her securities accounts (R.T. 1473-1476, 2900-2902; Plaintiff's Exhibit 202).

Mr. Wilder also prepared individual ledger sheets (Plaintiff's Exhibits 20A and 20B) for each security purchased in Mrs. Hecht's account and periodically prepared, showed and explained in detail to plaintiff general summaries of her account which he called "Condition of Account", "Report of Accomplishment", or "Summary of Operations" (R.T. 2154-2155; Plaintiff's Exhibits 20F1-20F13). The many false and misleading statements and

omissions in these summaries are analyzed in detail in Plaintiff's Trial Memorandum of Fact (C.T. 666-672, 695-711).

The trial court rightly found that these summaries were prepared in a manner to "allay any fear that the volume and frequency of the trading was excessive" and specifically found that the last such summary—dated March 29, 1963—was *misleading* and "would have given the impression that no excessive trading was going on." 283 F.Supp. at 434. See *infra*, pp. 28-31.

For further details of the relationship between Mr. Wilder and Mrs. Hecht illustrating his control over her and her financial affairs, see Plaintiff's Trial Memorandum of Fact (C.T. 590-595, 611-612).

Mr. Wilder's misuse of his dominion and control over Mrs. Hecht and her financial affairs is best illuminated by the two specific instances in which he converted her securities. In the *Itek* transaction, Mr. Wilder purchased in November 1958, on the basis of a rumor, a non-blue skyed security for Mrs. Hecht's account at 94 after purchasing the same security for his wife at 92 (R.T. 1451-1453, 1455, 3522; Plaintiff's Exhibit 311).

He was thereafter told by the firm to take the security out of the account as it could not legally be purchased in California. This Mr. Wilder did only after the passage of over three months by having the share certificates delivered to Mrs. Hecht (R.T. 1454-1455).

Without informing Mrs. Hecht of the fact that these securities were worth approximately \$30,000, Mr. Wilder "redeemed" Itek from her by giving her a check for \$9,400—the original purchase price (R.T. 1457-1459, 3585-3586; Plaintiff's Exhibits 301, 302).

The *Colonial* transaction involved what Mr. Wilder claimed was a "gift" of securities to him from Mrs. Hecht. Mrs. Hecht denied she made him a gift of these securities, worth over \$43,000, and the trial court agreed she had no understanding of this fraudulent transaction (R.T. 3479, 3586-3589, 3495-3496). Although he

claimed the securities were a gift, Mr. Wilder treated the transaction as a sale insofar as Mrs. Hecht's taxes were concerned, so that she not only had her securities converted, but also paid a capital gains tax on a long term gain of \$4,110¹². Although the transaction occurred in January 1961, Mr. Wilder buried it among the April entries on the capital gains schedule he prepared for that year—the only entry not in chronological order (R.T. 3493-3495; Plaintiff's Exhibit 20C-2).

For further details of these two remarkable transactions, including Mr. Wilder's failure to produce all documents in his possession relating to Itek when called upon to do so, see Plaintiff's Trial Memorandum of Fact (C.T. 653-658, 661-665) and 283 F.Supp. at 442-443.

Mr. Wilder's absolute control and dominion over Mrs. Hecht's financial affairs was only broken in March 1964, when her tax accountants demonstrated to her the declining net dividend income and the substantial losses in her account. After this revelation, an investment advisor and thereafter legal counsel were consulted and the account was transferred from Harris, Upham & Co. at the end of March 1964 (R.T. 1797-1799, 1805, 1896, 3071-3074, 2435-2436, 2783).

C. The Handling of Mrs. Hecht's Account

Churning and Unsuitable Management of the Account

As an elderly "retired widow" (R.T. 276, 1445-1446) of failing faculties who was "living on her own" (R.T. 1043) with no other means of support than dividend income realized from her securities (R.T. 1898), Mrs. Hecht's investment objectives and financial needs, and her understanding as to how the account was to be handled, called for the preservation of her capital and the receipt of a regular dividend income (R.T. 2427, 2895:10-11,

12. This action by Mr. Wilder is a vivid example of the old adage of "adding insult to injury."

2954-2957, 3036). See NASD Decision, Appendix A, pp. 18, 20.

The securities distributed to Mrs. Hecht from her husband's estate as well as those held in her own personal account were overwhelmingly dividend paying "blue chip" investment securities. When transferred by Mr. Wilder to Harris, Upham & Co. in May 1957, her securities were worth approximately \$533,000. (Plaintiff's Exhibits 324, 21A) If these securities had been retained, they would not only have almost doubled in value (to \$1,026,775—Plaintiff's Exhibit 271A) but would have also returned to Mrs. Hecht an annual dividend income of between \$26,000 and \$32,000 (Plaintiff's Exhibit 280-1).

Rather than maintaining this account virtually intact as dictated by suitable investment management (See Plaintiff's Trial Memorandum of Fact, C.T. 673-675, 680-681), defendants actively, excessively and unsuitably traded it, to plaintiff's substantial detriment. The trial court's holding that the account was improperly churned and managed has been confirmed by the NASD conclusions that:

"... each and every transaction effected in Mrs. Hecht's securities account was excessive in size and frequency, in relation to the character and resources of her account. . . . We further find that such violations by Mr. Wilder represent conduct inconsistent with just and equitable principles of trade.

"... each of [the commodities] transactions individually, or all of them in the aggregate, constitute a misuse and unsuitable use of her funds for the purpose of 'churning' her account, all of which was fraudulent in nature . . . taking into consideration the financial situation and needs of Mrs. Hecht.

"... as a whole the account was improperly managed [by Mr. Wilder] . . . and that each and every transaction, considered in relation to all other transactions and in relation to the account overall, was unsuitable.

"The act of putting an elderly widow of failing faculties into non-income producing and speculative holdings is itself an act of 'unsuitability' of such magnitude to require revocation." NASD Decision, Appendix A, pp. 20-21.

These conclusions are abundantly substantiated by the figures relating to the handling of Mrs. Hecht's account. During the years her account was at Harris, Upham & Co., security purchases in the amount of \$4,921,279 and security sales of \$4,766,129 were effected, a total dollar volume of \$9,687,408 (Plaintiff's Exhibit 271 (p. 31)). The securities account alone was turned over from 11.5 to 11.7 times (Plaintiff's Exhibits 271A, 288) and shows an "in and out" trading pattern in that 45% of the securities were held six months or less before being sold while 82% were held less than 12 months (Plaintiff's Exhibit 271A).

During this period plaintiff was charged agency commissions of \$76,000 and principal mark-ups of an additional \$15,000, a total of \$91,000, on security transactions effected for her account (Plaintiff's Exhibits 283, 296; R.T. 3210-3212). She was further charged over \$43,000 in interest on the debit balance in her margin account (Plaintiff's Exhibit 289).

In plaintiff's commodities account, defendants effected commodity futures purchases worth \$44,795,105 and sales worth \$44,679,566, a total of over \$89 million on some 8,900 transactions (Plaintiff's Exhibit 293). Plaintiff was charged \$98,000 in commissions on these transactions and sustained additional realized losses of \$78,000, for a total loss of \$176,000 (Plaintiff's Exhibits 283, 292).

The importance of plaintiff's account to defendants as a source of income is best indicated in graphic form. Chart I below sets forth by year during the life of plaintiff's account, the commodity commissions for the entire San Francisco office, the commodity commissions generated by Mr. Wilder, the commodity commissions paid by Mrs. Hecht, and her commissions as a percentage

of those of Mr. Wilder and of the San Francisco Office. For at least the period 1962 through March 1964, there were no commodities accounts at the San Francisco office which paid more in commissions than did plaintiff (Plaintiff's Exhibit 192-2(37)).

Chart I
COMMODITY COMMISSIONS

| Year | Total Commissions of S.F. Office | Total Commissions by Wilder | Commissions Paid by Hecht | Hecht as % of Totals: | |
|---------------------|--|-----------------------------------|------------------------------|--------------------------|------------|
| | | | | Wilder | S.F. |
| 1957 | \$ 14,308 | \$ 9,587 | \$ 3,162 | 33.0% | 22% |
| 1958 | 37,057 | 23,812 | 9,885 | 41.5% | 27% |
| 1959 | 66,663 | 31,542 | 16,110 | 51.1% | 24% |
| 1960 | 45,078 | 21,025 | 10,760 | 51.2% | 24% |
| 1961 | 59,313 | 34,011 | 23,257 | 68.4% | 39% |
| 1962 | 39,477 | 19,351 | 14,898 | 76.0% | 38% |
| 1963 | 46,344 | 25,842 | 19,642 | 76.0% | 42% |
| 1964 (Jan-Mar) | 5,806 | 1,477 | 624 | 42.0% | 11% |
| Totals | <u>\$314,046</u> | <u>\$166,647</u> | <u>\$98,338</u> | <u>59.0%</u> | <u>31%</u> |

Compiled from Plaintiff's Exhibits 192-2(35), 233, 283

The following chart reflects the agency commissions paid to Harris, Upham & Co. by Mrs. Hecht on securities transactions as compared to all securities commissions generated by Mr. Wilder.

Chart II
SECURITIES COMMISSIONS

| Year | Total Commissions of Wilder | Commissions Paid by Hecht | Hecht as % of Total for Wilder |
|----------------------|-----------------------------------|------------------------------|--------------------------------------|
| | | | |
| 1957 | \$ 17,925 | \$ 6,425 | 35.8% |
| 1958 | 27,081 | 13,762 | 50.8% |
| 1959 | 28,406 | 11,934 | 42.0% |
| 1960 | 23,176 | 12,537 | 54.1% |
| 1961 | 55,216 | 18,971 | 34.3% |
| 1962 | 23,303 | 7,456 | 32.0% |
| 1963 | 14,516 | 4,100 | 28.0% |
| 1964 (Jan-Mar) | 4,768 | 1,378 | 28.9% |
| Totals | <u>\$194,391</u> | <u>\$76,563</u> | <u>39.4%</u> |

Compiled from Plaintiff's Exhibits 192-2(35), 233 and 283

This chart does not include as part of the commissions paid by Mrs. Hecht the additional \$15,000 she was charged by Harris, Upham & Co. as mark-up on principal over-the-counter transactions (Plaintiff's Exhibit 296; R.T. 3210, 3212).

Chart III compares the combined securities and commodities commissions paid by Mrs. Hecht to the total of such commissions generated by Mr. Wilder.

Chart III
SECURITIES AND COMMODITIES COMMISSIONS

| Year | Total Commissions of Wilder | Commissions Paid by Hecht | Hecht as % of Total for Wilder |
|----------------------|-----------------------------------|------------------------------|--------------------------------------|
| 1957 | \$27,512 | \$ 9,587 | 35 % |
| 1958 | 50,893 | 23,647 | 46 % |
| 1959 | 59,948 | 28,044 | 47 % |
| 1960 | 44,201 | 23,297 | 53 % |
| 1961 | 89,227 | 42,228 | 48 % |
| 1962 | 42,654 | 22,354 | 52 % |
| 1963 | 40,358 | 23,742 | 59 % |
| 1964 (Jan-Mar) | 6,245 | 2,002 | 32 % |
| Totals | <u>\$361,038</u> | <u>\$174,901</u> | <u>48.4%</u> |

That this one account was the source of nearly 50% of Mr. Wilder's total income production for the firm is indicative of its importance to him in maintaining and increasing his compensation from the firm. That Mrs. Hecht's account produced commissions and interest representing, at a minimum, 4.7% of the total income of the San Francisco office shows the importance of the account to Harris, Upham & Co. (See C.T. 734). *The \$232,000 in commissions, mark-ups and interest charged Mrs. Hecht represents over 40% of the initial value of her account.*

It is obvious from the following table that Harris, Upham & Co. compensated Mr. Wilder in relation to the income from Mrs. Hecht's account:

Chart IV

| Year | Commissions and Interest Paid by Mrs. Hecht | Wilder's Compensation |
|----------------------|---|---------------------------------------|
| 1957 (May-Dec) | \$ 10,182 | \$ 10,000 |
| 1958 | 25,939 | 15,000 |
| 1959 | 31,658 | 15,000 |
| 1960 | 30,290 | 15,000 |
| 1961 | 52,114 | 27,500* |
| 1962 | 31,223 | 18,000 |
| 1963 | 31,974 | 15,525 |
| 1964 (Jan-Mar) | 5,026 | 3,750 |
| 1964 (Apr-Dec) | — | 8,450 |
| Totals | <u>\$218,406**</u> | <u>\$119,775 (through</u> 3/31/64) |

Compiled from Plaintiff's Exhibits 283, 233; Defendant's Exhibit S-5

As indicated above, Mr. Wilder received two \$5,000 bonuses, the first on June 30, 1961 and the second on January 15, 1962 (Plaintiff's Exhibit 233; R.T. 1370). It is clear that these bonuses, as well as a salary increase in March 1961 from \$1,250 to \$1,500 per month, reflect the tremendous increase in income generated from Mrs. Hecht's account in 1961 (R.T. 1370-1371). In June 1964, after Mrs. Hecht's account was transferred, Mr. Wilder's salary was reduced from \$1,250 to \$850 per month (Plaintiff's Exhibit 233).

It is relevant here to note the fact that both Mr. Wilder and Harris, Upham & Co. denied under oath during pre-trial that Mr. Wilder had received bonuses and that they also withheld information from plaintiff on the amount of commissions generated by Mr. Wilder for the years prior to 1962. See Plaintiff's Trial Memorandum of Fact (C.T. 622-627).

When Mrs. Hecht's account was removed from Harris, Upham & Co. in March 1964, it had a net value of approximately \$251,000 (Plaintiff's Exhibit 285) as compared to its initial value of \$533,-

*Including bonuses of \$5,000 each paid on 6-30-61 and 1-15-62.

**This figure does not include the \$15,000 paid by Mrs. Hecht as mark-up on principal over-the-counter transactions.

000. *There was at this time an unrealized loss on the securities in the account of over \$102,000 and approximately 40% of the securities then in the account (based upon cost) were given speculative ratings by independent rating services (R.T. 1908-1910, 1902-1903).*

While plaintiff's account value declined by over 50%, security values in general were rising sharply. Between the end of April 1957 and March 31, 1964, the Dow Jones industrial average rose from 494.36 to 815.24 (Defendants' Exhibit S-1), a percentage increase of 165%. During the same period the Standard and Poor's 500 stock average rose 170%, from 50.10 to 84.92. Had plaintiff's original portfolio been maintained intact, it would have had a value on March 31, 1964 of \$1,026,000 (Plaintiff's Exhibit 271A).

Many of the securities purchased (and all of the commodities purchased) were unsuitable for plaintiff in that they were non-dividend paying. *By March 1964, Mrs. Hecht's net annual dividend income (after deducting the interest paid on the margin debit) was reduced to approximately \$1,000 (R.T. 1900-1901) whereas in 1958 (the first full calendar year the account was at Harris, Upham & Co.) her net dividend income was \$17,854 (Plaintiff's Exhibit 282).* Over the life of the account, had her original portfolio been maintained, plaintiff would have received net dividend income of \$108,000 and gross dividend income of \$70,000 more than she actually did receive (Plaintiff's Exhibits 280-282).

The following chart reveals the declining net income received on Mrs. Hecht's account.

Chart V

NET INCOME RECEIVED ON SECURITIES

| Year | Dividends and Bond Interest Credited to Account | Interest Charged Margin Account by Harris, Upham & Co. | Net Income to Mrs. Hecht |
|--------------|--|---|-----------------------------|
| 1957 | \$ 10,553 | \$ 595 | \$ 9,958 |
| 1958 | 20,146 | 2,291 | 17,855 |
| 1959 | 18,555 | 3,490 | 15,065 |
| 1960 | 20,305 | 6,993 | 13,312 |
| 1961 | 21,453 | 9,891 | 11,562 |
| 1962 | 15,710 | 8,869 | 6,841 |
| 1963 | 13,042 | 8,232 | 4,810 |
| 1964 | 3,403 | 3,119 | 284 |
| Totals | \$123,167 | \$43,480 | \$79,687 |

Compiled from Plaintiff's Exhibit 289

For further details demonstrating the unsuitable and improper handling of plaintiff's account, see Plaintiff's Trial Memorandum of Fact (C.T. 673-681).

Short Sales

Another impropriety in the handling of plaintiff's account was the effectuation by Mr. Wilder of short sales in three different securities. Short sales are admitted by defendants to be speculative (R.T. 286) and are considered by Harris, Upham & Co. to be an unusual transaction requiring investigation when affected for the account of a woman (R.T. 1206; Plaintiff's Exhibit 15 (p. 1)). Both Harris, Upham & Co.'s New York Executive Office and its San Francisco Branch Office failed to make the required investigation of these short transactions in plaintiff's account and as a result Mrs. Hecht sustained a loss of \$10,457 (Plaintiff's Exhibits 20A, 20B). For further details see Plaintiff's Trial Memorandum of Fact (C.T. 628-629).

Commodities Transactions

Prior to Mr. Wilder's taking over the management of her financial affairs, Mrs. Hecht had never dealt in commodities (R.T. 2433). In June 1956, Mr. Wilder opened a commodities account

in Mrs. Hecht's name and induced her to write a letter enclosing a check for the purchase of soybeans. Although only \$32,500 was directly deposited in the commodities account, the incredible volume of \$89 million worth of commodity futures transactions was financed by the transfer of funds from the securities account (Plaintiff's Exhibits 263, 288).

Not only was Mrs. Hecht unaware of these transfers, but it is clear that she lacked any comprehension of commodities and of the risks they entail. Commodity futures do not pay dividends and are a speculative trading vehicle totally unsuited to one concerned with the preservation of capital and the receipt of dividend income (R.T. 1820-1821). The inappropriateness of commodities for women is acknowledged by Harris, Upham & Co.'s own policies, here unobserved, which prohibit women from engaging in commodities transactions unless a partner and the commodities manager are satisfied she has "sufficient experience and knowledge of commodity trading" and is "fully aware of the risks involved (including those of 'spread') and is financially able to assume such risks" (Plaintiff's Exhibits 236 (p.2), 13 (p.10)). Mrs. Hecht lacked such experience and knowledge and also lacked the other personal characteristics required of one dealing in commodity futures (Plaintiff's Exhibits 260 (pp. 3-4)).

The commodity business consists of transactions in "cash commodities" and transactions in commodity future contracts, i.e., contracts for the future delivery of an actual commodity. See generally, Gerald Gold, *Modern Commodity Futures Trading* (4th Ed. 1966).

Commodities are referred to as "regulated" or "unregulated". Under the Commodity Exchange Act certain domestic agricultural commodities (e.g. wheat, corn, rye, oats, soybeans and cotton) are regulated. Unregulated commodities consist primarily of internationally traded commodities, such as sugar, cocoa and coffee, and such metals as silver and platinum.

Between May 1, 1957 and March 31, 1964, acting as Harris, Upham & Co.'s San Francisco Commodity Manager, Mr. Wilder recommended and effected (R.T. 1435-1438) 8904 "future transactions"¹³ with a total market value of \$89 million in the following commodity futures for Mrs. Hecht's account:

| Regulated | Unregulated |
|---|--------------------------|
| lard | platinum |
| soybean oil | copper |
| soybean meal | silver |
| soybeans | sugar Nos. 3, 4, 7 and 8 |
| corn | cocoa |
| eggs | |
| potatoes | |
| Chicago, Minneapolis and Kansas City wheat | |
| rye | |
| oats | |
| cotton | |

Between May 1, 1957 and March 31, 1964, Mr. Wilder effected 4457 "closed" commodity future transactions (i.e., an original position liquidated by an offsetting transaction) for Mrs. Hecht's account as follows:

| Year | No. of Contracts |
|----------------------|---------------------|
| 1957 (May-Dec) | 181 |
| 1958 | 439 |
| 1959 | 656 |
| 1960 | 540 |
| 1961 | 1063 |
| 1962 | 696 |
| 1963 | 856 |
| 1964 (Jan-Mar) | 26 |
| TOTAL..... | <u>4457</u> |

There was a loss of over \$9,000 on closed commodity transactions, and transactions of a total value in excess of \$309,000 were

13. Defined as "purchases plus sales in terms of contract units". *Commodity Futures Statistics*, United States Department of Agriculture, Commodity Exchange Authority, Statistical Bulletin No. 32, p. 4 (January 1967).

effected in Mrs. Hecht's account at Harris, Upham & Co. during May and June 1957, the very first two months the account was handled by it (Plaintiff's Exhibit 22A). No supervisory officer of Harris, Upham & Co., however, discussed the suitability or propriety of these transactions with Mr. Wilder, even though the account was newly opened by a new Commodities Manager for a retired elderly widow who lived alone (R.T. 1449).

Selective Close-Out Scheme

Mr. Wilder's handling of Mrs. Hecht's commodity account went entirely without supervision by Harris, Upham & Co. (R.T. 1438-1440). This practice permitted Mr. Wilder to engage in a calculated scheme of selective close-outs designed to conceal from Mrs. Hecht the losses occurring in her account and thereby permit him to continue to churn her account and maintain his faltering commission production.

During 1962 and early 1963, the volume of business generated by Mr. Wilder declined. As a result, his salary was reduced from \$1,500 to \$1,275 a month beginning in March and then to \$1,250 a month in April (Plaintiff's Exhibit 233). Aware of this salary cut and faced with the possibility of even further reductions, Mr. Wilder devised a scheme to continue the high level of commodity activity in plaintiff's account while concealing from her the substantial losses occurring from this activity.

Beginning in February 1963, Mr. Wilder instructed Harris, Upham & Co.'s Commodities Department in New York, by use of the firm's private wire system, to close out commodity transactions on other than a first-in, first-out basis. The following table reveals that by making such selective close-outs, Mr. Wilder showed a net profit on these 14 transactions of over \$2,300, whereas if properly effected there would have been a loss of over \$27,000.

Chart VI
SELECTIVE CLOSE-OUTS

| Date 1963 | As Rendered | | If Close-Out Had Been Against Oldest Open Position | |
|---------------------|-------------|------------|--|--------|
| | Loss | Profit | Loss | Profit |
| Feb. 20—20M Bu | | | | |
| Mar. soybeans | \$1,327.25 | | \$ 2,477.25 | |
| March 13—20M Bu | | | | |
| July soybeans | | \$ 660.25 | 2,546.00 | |
| March 14—20M Bu | | | | |
| July soybeans | | 354.00 | | \$4.00 |
| March 15—20M Bu | | | | |
| May wheat | | 274.00 | 501.00 | |
| March 22—10M Bu | | | | |
| July wheat | | 106.00 | 637.75 | |
| March 28—10M Bu | | | | |
| July wheat | | 68.50 | 681.50 | |
| March 28—20M Bu | | | | |
| May soybeans | | 370.50 | 6,442.00 | |
| March 28—10M Bu | | | | |
| Aug. soybeans | | 89.50 | 2,098.00 | |
| April 18—20M Bu | | | | |
| May soybeans | | 104.00 | 2,346.00 | |
| May 8—20M Bu | | | | |
| Aug. soybeans | | 129.00 | 3,446.00 | |
| May 15—10M Bu | | | | |
| May rye | | 168.50 | 544.00 | |
| May 21—20M Bu | | | | |
| July soybeans | | 133.00 | 567.00 | |
| May 28—20M Bu | | | | |
| July soybeans | | 204.00 | 196.00 | |
| July 25—50M Bu | | | | |
| Aug. soybeans | | 1,010.00 | 5,340.00 | |
| Totals | \$1,327.25 | \$3,671.25 | \$27,822.50 | \$4.00 |

Although all of the above figures are contained in or are computable from exhibits in evidence in this trial (Plaintiff's Exhibits 20D-1, 22J, 22L, 20H), it required the expertise of, and an extended investigation by, the Commodity Exchange Authority (hereafter CEA), a part of the United States Department of Agriculture, to unearth this subtle scheme. Such selective close-outs on other than a first-in, first-out basis violate Section 1.46 of the regulations issued by the CEA pursuant to the Commodity Exchange Act (17

C.F.R. § 1.46). As a result, Harris, Upham & Co. and Mr. Wilder were found to have violated the regulations and an administrative proceeding was instituted against Mr. Wilder. *In the Matter of Asa V. Wilder, CEA Docket No. 158.*

False Summary of March 29, 1963

The concealment from Mrs. Hecht of these commodities losses makes even more significant the false and misleading March 29, 1963 "Summary of Operations" prepared by Mr. Wilder (Plaintiff's Exhibit 20F-1) which is here printed for the convenience of the Court.

SUMMARY OF OPERATIONS

Account at close of business March 29, 1963

| | | |
|------------------------------------|------------------|-------------------|
| Value of securities deposited..... | | \$353,680.00 |
| Total Net Gain to date..... | | <u>253,493.00</u> |
| Value without withdrawals..... | | \$607,173.00 |
| Withdrawals | | |
| Years 1958-59-60 | \$92,440.00 | |
| Year 1961 | 54,380.00 | |
| Year 1962 | <u>80,616.00</u> | <u>227,436.00</u> |
| Present Value March 29, 1963..... | | \$379,737.00 |

No account has been taken of any withdrawals made in the years 1956 and 1957. In the five years from 1958 through 1962 inclusive nearly a quarter of a million dollars or about two-thirds of the original value has been withdrawn and the account still has a value greater than the original amount.

Mr. Wilder testified that he showed and discussed this Summary in some detail with Mrs. Hecht at the "first opportunity" after her return from the hospital in April 1963 (R.T. 1280-1281, 2154-2155, 1325). He did not, however, inform her tax accountants of its existence or ask them to review his figures (R.T. 1772-1773, 1325-1327).

The Summary was prepared by Mr. Wilder in the ordinary course of his duties as a broker and was typed under his direction and supervision at the Harris, Upham & Co. office (R.T. 1299, 1279-1280). A detailed analysis of the Summary reveals a number of misleading representations and omissions.

"Value of Securities Deposited (\$353,680.00)"

The Summary does not indicate the date of valuation and erroneously suggests that Mrs. Hecht's securities were worth only \$353,680.00 when deposited at Harris, Upham & Co. in 1957 or when earlier deposited with Hooker & Fay.

To arrive at this figure, Mr. Wilder took the **cost basis** of the securities in the estate of Herbert Hecht, which amount (\$300,650) was the market value as of the date of death—*January 12, 1955*—rather than the market value of the securities when "deposited" into Mrs. Hecht's account at Hooker & Fay in August 1956 or at Harris, Upham & Co. in May 1957 (R.T. 1284, 1312:3-8).

In fact, the market value of the securities received from the estate on September 6, 1956, shortly after they were distributed in August 1956, was \$362,739 as computed from Mr. Wilder's own figures in his summary entitled "Close Sept. 6th 1956" (Plaintiff's Exhibit 20F-13). *The figure shown on the Summary of Operations for the value of securities deposited is, therefore, understated by the difference between the cost basis and the actual market value—an amount in excess of \$62,000.*

Mr. Wilder used as the value of Mrs. Hecht's Walston & Co. account the amount of \$35,975, computed at the time of transfer to Hooker & Fay in July 1955 (R.T. 1316-1317). This value is understated by approximately \$8,000 (R.T. 1319-1322; Plaintiff's Exhibit 255).

Finally, Mr. Wilder added to his figure for the value of the securities deposited the January 1955 cost basis rather than the market value of the 100 AT&T received into Mrs. Hecht's account at Harris, Upham & Co. from the estate of Herbert Hecht in 1958 (R.T. 1317-1318).

The value of the original account is further understated by the omission of the \$122,000 cash deposited into the account by Mrs. Hecht in 1955, 1956 and 1957 (Plaintiff's Exhibits 289, 27E).

"Withdrawals (\$227,436.00)"

Without disclosing that he has done so, Mr. Wilder included in the term "*Withdrawals*" the following:

1. *Interest paid by Mrs. Hecht to Harris, Upham & Co. on the debit balance in the margin account (R.T. 1285).*
2. *Dividends and bond interest received on Mrs. Hecht's securities which were paid out to her (R.T. 1285-1287).*
3. *Withdrawals of capital made by Mrs. Hecht to pay taxes, etc. (R.T. 1288:1-5).*

Mr. Mejia has admitted that dividends are not a "withdrawal" because they are "not a reduction of equity" and that it could be misleading to consider interest charged by Harris, Upham & Co. as a "withdrawal" from a client's account (R.T. 529-531).

Mr. Wilder's Summary of Operations is also misleading in stating that *no account* has been taken of any "*withdrawals*" made in the years 1956 and 1957". That Mr. Wilder should omit these two particular years is highly significant since during these two years Mrs. Hecht deposited cash in her account in excess of \$118,000 (Plaintiff's Exhibits 287, 27E). Even after subtracting "*withdrawals*" as peculiarly defined by Mr. Wilder, there would be a net credit to Mrs. Hecht's account of some \$74,000 for the years 1956 and 1957.

The statement that no account had been taken of any withdrawals made in the years 1956 and 1957 is also false. The figures for withdrawals in the year 1958 does in fact include a check for \$8,000 paid to Mrs. Hecht on November 26, 1957 (R.T. 1301).

"Total Net Gain to Date (\$253,493.00)"

Mr. Wilder arrived at this figure by adding what he has computed as "*withdrawals*" to his determination of the market value of Mrs. Hecht's account on March 29, 1963, and then subtracting his understated value of the securities deposited (R.T. 1308-1309). Therefore, as part of the "*gain*" Mr. Wilder has included the substantial amounts of interest paid to Harris, Upham & Co.

by Mrs. Hecht plus the dividends and bond interest received on her securities. For the years 1958-1962, interest paid was in excess of \$31,000 and dividends received exceed \$96,000 (Plaintiff's Exhibit 289). *It is clear that had Mr. Wilder properly computed the original value of Mrs. Hecht's account and only included actual capital withdrawals, there would have been no "Net Gain to date"*.

Commodity Futures Position

While including the credit balance in the commodities account in his computation of the present value of plaintiff's account, Mr. Wilder fails to include the potential gain or loss on commodities then held in the account (R.T. 1302-1303). *As of March 29, 1963, there was an unrealized loss of over \$27,000 on the commodities then held* (Plaintiff's Exhibit 294) which, if included, would have decreased the "Net Gain" by a like amount.

The selective close-out scheme substantially increased the deception practiced on Mrs. Hecht. Had the transactions been properly effected, the losses would have reduced the credit balances in the commodities account and thereby reduced the present value of the account shown on the Summary. Instead, Mr. Wilder materially deceived Mrs. Hecht as to the condition of her account by making such selective close-outs and then not reflecting the tremendous unrealized commodity loss position in his Summary.

This Summary was the last one prepared by Mr. Wilder and appears to have been presented at this time both to take advantage of Mrs. Hecht's poor health and of the benefits reaped from the selective close-outs scheme. A summary of the account later on in 1963 or in 1964 reflecting the realized commodity losses (over \$116,000 for 1963) would have revealed a substantially deteriorated condition of the account. Neither the understatement of the original value of plaintiff's account nor the improper definition of withdrawals would have been enough to disguise the decline in value of the account over the years.

Other False Summaries

The misrepresentations in other summaries prepared by Mr. Wilder are discussed in Plaintiff's Trial Memorandum of Fact (C.T. 695-711).

ARGUMENT**I**

PLAINTIFF WAS NOT BARRED BY ESTOPPEL, WAIVER OR LACHES FROM RECOVERING A FULL MEASURE OF THE DAMAGES SHE SUSTAINED.

The trial court restricted plaintiff's damages to those which it considered were caused by the churning of her account, while denying her damages based upon a comparison of proper management with the actual management of her account, because it held that she had "assumed the ordinary risks of profit or loss in what she knew to be a trading account in securities and a speculative account in commodities." 283 F.Supp. at 430. The trial court concluded that plaintiff

"permitted Wilder and his firm to continue handling the account on this basis in reliance upon her apparent acquiescence for nearly seven years"

and therefore

"plaintiff's *conduct* is such that she is barred by estoppel, laches and waiver (within the meaning of the second appeal in *Royal Air Properties v. Smith*, 333 F.2d 568 (1964)) from suddenly taking the position that such trading of the account in securities and commodities was unsuitable for her needs and objectives, contrary to her instructions and should never have occurred." 283 F.Supp. at 429-430 (emphasis added).

This conclusion, it is submitted, is erroneous both as a matter of law and of fact.

**A.
ESTOPPEL**

1. ESTOPPEL IS INAPPLICABLE AS A MATTER OF LAW.

The equitable defense of estoppel is only "to be applied against wrongdoers, not against the victim of a wrong." *Roberts v. Roberts*, 81 Cal.App.2d 871, 881 (1947). See also, *Edgington v. Security-First Nat. Bank*, 78 Cal.App.2d 849, 858 (1947) (estoppel "is not intended to be used for the purpose of permitting one to perpetuate a fraud upon another"; *Westinghouse Electric Corp. v. Pacific Gas & Electric Co.*, 326 F.2d 575, 580 (9th Cir. 1964) (recognizing the fundamental principle that "no man may take advantage of his own wrong.") The defense of estoppel, therefore, cannot here be invoked against Mrs. Hecht who was the victim rather than the perpetrator of the wrong committed.

Further, this Court has stated there can be no estoppel as a matter of law where there is a concomitant duty of due care.

Hampton v. Paramount Pictures Corp., 279 F.2d 100, 104-105 (9th Cir. 1960), cert. denied, 364 U.S. 882 (1960)

Harris, Upham & Co. failed in its duty to properly manage Mrs. Hecht's account and to institute and maintain an adequate system of supervision over its employees to insure that customers were protected against fraud and that their funds were suitably and properly handled and invested. *Reynolds & Co.*, 39 S.E.C. 902, 917 (1960); *R. H. Johnson & Co.*, 36 S.E.C. 467, 486-487 (1955); NASD Decision, Appendix A, pp. 18, 20.

2. THE FACTUAL ELEMENTS NECESSARY TO ESTABLISH AN ESTOPPEL WERE NOT PROVEN.

To establish the defense of estoppel it is necessary to prove four elements:

"(1) The party to be estopped must know the facts; (2) he must intend that his conduct shall be acted on or must so act that the party asserting the estoppel has a right to believe it is so intended; (3) the latter must be ignorant of the true facts; and (4) he must rely on the former's conduct

to his injury." *Hampton v. Paramount Pictures Corp.*, 279 F.2d 100, 104 (9th Cir. 1960).

See also, *Estoppel*, 18 Cal Jur. 2d 406-407; *Belhumeur v. Dawson*, 229 F.Supp. 78, 86-87 (D. Mont. 1964).

First, plaintiff did not know the true facts regarding the improper handling of her account. Because of Mr. Wilder's practice of picking up all the account papers sent to her by Harris, Upham & Co., Mrs. Hecht never had in her possession at any one time sufficient information for any person to intelligently analyze the handling of her account. Further, the monthly account statements sent by Harris, Upham & Co. were deficient in many respects and failed to disclose the information necessary for a proper valuation of the account. See Plaintiff's Trial Memorandum of Fact, C.T. 651-652. Most importantly, Mr. Wilder concealed from Mrs. Hecht the true condition of her account by means of the false and misleading summaries he prepared and showed to her. Because of these facts, Mrs. Hecht was neither capable of making nor in a position to make a knowledgeable assumption of risk. *Weiser v. Schwartz*, CCH Fed. Sec. L. Rep., para. 92,286 (E.D. La. 1968), p. 97,374.

Secondly, *plaintiff never intended* that her conduct (i.e., her failure to object) be relied upon by or mislead defendants to their detriment nor did defendants have a right to believe such was her intent.

California State Board of Equalization v. Coast Radio Products, 228 F.2d 520, 525 (9th Cir. 1955) ("An estoppel arises where one party by concealment or false representation *intentionally* deceives another party as to the true state of facts to the *detriment* of the second party.")

Matsuo Yoshida v. Liberty Mutual Ins. Co., 240 F.2d 824, 829-830 (9th Cir. 1957) (Estoppel is conduct which "reasonably misleads another to his prejudice so that a repudiation of such conduct would be unjust in the eyes of the law.")

Cal. Cigarette Concessions v. City of Los Angeles, 53 Cal.2d 865, 870-871 (1960)

Prosser on Torts, 707 (3rd Ed. 1964) ("There is no estoppel where he has remained silent reasonably and in good faith; he must be aware of his rights and must realize that the other is about to act under a mistaken belief.")

Thirdly, defendants were not ignorant of the true facts. To the contrary, they misrepresented and concealed the true facts from plaintiff. *Sidebotham v. Robinson*, 216 F.2d 816, 829 (9th Cir. 1954).

At all times the facts regarding Mrs. Hecht's investment needs and objectives and the handling of her account were fully available to defendants from the account papers and other documents in their possession. Defendants point to no facts known by plaintiff but unknown to them which, if known, would have caused them to act other than they did.

Finally, it is clear that Harris, Upham & Co. did not rely on Mrs. Hecht to its injury. This Court has stated that:

"The defenses of laches and estoppel do not spring principally from intent, as does waiver, but from *injury to the deceived party* caused by neglect or misleading action to the delaying party." *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568, 571 (9th Cir. 1964) (emphasis added).

See also, *Moran v. Paine, Webber, Jackson & Curtis*, 279 F. Supp. 573, 579 (W.D.Pa. 1967), *aff'd* 389 F.2d 242 (3rd Cir. 1968), ("There has been shown no reliance by defendant upon plaintiff's conduct to its injury.")

Harris, Upham & Co. introduced no evidence indicating it was "injured" by defrauding plaintiff over a nearly seven-year period. To the contrary, it was unjustly enriched by the taking of \$232,000 in commissions and interest from plaintiff's account. To permit a claim of estoppel in such circumstances would be analogous to denying the victim of a battery compensation for all injuries sustained on the basis she did not call for help quite as soon as she might.

It is apparent that it is plaintiff and not defendants who detrimentally relied on the other's conduct. It is also apparent that plaintiff was the victim of a calculated, deliberate and fraudulent scheme and that the true facts concerning the transactions in and the condition of her account were misrepresented to and concealed from her. There is, therefore, no basis in fact or in law for applying the doctrine of estoppel to deny plaintiff compensation for all damages sustained.

B.

LACHES

1. THE DEFENSE OF LACHES CANNOT HERE BE APPLIED.

The defense of *laches* exists only where the elements are shown which would support a finding of estoppel. To have prevailed with this defense, defendants would have had to prove, which they did not, both that they were "deceived" by plaintiff and that they were injured through reliance on her conduct. *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568, 570-571 (9th Cir. 1964). Nor can laches be invoked in an action for damages. *Straley v. Universal Uranium and Mill. Corp.*, 289 F.2d 370, 373 (9th Cir. 1961).

C.

WAIVER

1. WAIVER OF RIGHTS UNDER THE SECURITIES ACTS CAN ONLY BE FOUND WHEN THERE IS EXPRESS, INTENTIONAL AND UNEQUIVOCAL CONDUCT EVIDENCING THE WAIVER.

The mere fact that Mrs. Hecht failed to object to the handling of her account prior to March 1964—the only conduct of plaintiff relied upon by the trial court to support its finding of waiver—cannot be deemed a waiver of any of her claims.

Such a waiver can only be found when there is *express intentional conduct*:

"When waiver is predicated upon facts of which one has inquiry, but not actual notice, it is no longer intentional. We feel that *waiver of rights under the Securities Exchange Act of 1934* should be limited to those cases where it is intended, and that therefore the right in question must be found to be actually known before waiver becomes effective."

" . . . no detriment to a third party is required for waiver, it is unilaterally accomplished. *We therefore see no reason to find a waiver if one has not acted with full knowledge of his rights.*"

Royal Air Properties, Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1964) (emphasis added)

Waiver is not to be implied contrary to a party's intention and doubtful cases are to be decided against a waiver.

Xum Speegle, Inc. v. Fields, 216 Cal.App.2d 546, 555 (1963)

To sustain a claim of intentional waiver, defendants were required to establish, which they did not do, that Mrs. Hecht was fully aware of her rights under the Securities Exchange Act and with full knowledge of them intentionally acted to the contrary.

The failure of defendants to meet this strict standard is made clear by a comparison with the *Smith* case.

Misrepresentations were made to Dr. Smith inducing him to make a substantial investment in a small closely held corporation. Dr. Smith was elected a director and both he and his attorney attended meetings of the Board of Directors. The defendants asserted that Smith, as a reasonable man, should have known of the misstatements and omissions at least two years before he brought suit and that he failed to act because he anticipated that a reasonable profit would be made on his investment.

Whether Dr. Smith had been victimized depended upon the date another investor demanded the return of his investment. Although this demand was discussed at a Board of Directors meeting attended by Dr. Smith, not until two years later was he explicitly and expressly informed of the date.

With this background, this Court approvingly quotes the trial court:

"The court remains of the opinion expressed at the time of the original trial, namely, *that there were many factors*

which should have aroused plaintiff's suspicions about the true nature of affairs within the defendant corporation and that it would not have been difficult for him to have fully informed himself. The court believes now, as it did then, that he was negligent—perhaps grossly so—in this regard, but such failure does not necessarily defeat his recovery here. He was exceedingly gullible in that he was overtrusting, but this is understandable in view of the fact that his professional activities are wholly divorced from the world of business.” 333 F.2d at 572 (emphasis added).

This Court then concludes:

“Since full knowledge of the Hargiss claim did not come to appellee until after he had done the acts claimed to evidence waiver, no waiver occurred.” 333 F.2d at 572 (emphasis added).

If Dr. Smith did not waive any rights after his attorney talked to Hargiss about the subject matter of the alleged waiver, it is apparent that Mrs. Hecht cannot be said to have waived any of her claims. She talked to no one prior to March 1964 about her account and was not expressly informed of its greatly deteriorated condition, that non-dividend paying and otherwise unsuitable securities were purchased for her account, that commodities and short transactions were inappropriate for one in her circumstances and were resulting in tremendous losses, and that Mr. Wilder had converted her securities. The full extent of the improper handling of plaintiff's account and the resulting damage, and therefore the fact and nature of plaintiff's rights under the Securities Exchange Act, were determined only after exhaustive accounting, investment and legal analysis—all performed after March 1964, subsequent to “the acts claimed to evidence waiver”.

Congress has specifically invalidated prior agreements which waive the protections of the Securities acts. Securities Act of 1933 § 14 (15 U.S.C.A. § 77 n); Securities Exchange Act of 1934 § 29(a) (15 U.S.C.A. § 78 cc(a)). The courts have uniformly en-

forced these provisions. E.g., *Wilko v. Swan*, 346 U.S. 427, 74 S.Ct. 182, 98, L.Ed. 168 (1953); *Reader v. Hirsch & Co.*, 197 F. Supp. 111, 116 (S.D.N.Y. 1961). Waivers alleged to arise from an assumption of risk should likewise be severely restricted and found to occur only when it is abundantly clear such a waiver was intended by the party against whom it is asserted. *The mere failure to object to another's course of conduct without full knowledge of the facts is not sufficient.*

2. MRS. HECHT DID NOT WAIVE HER RIGHT TO DAMAGES ARISING FROM THE PURCHASE OF SPECULATIVE, LOW-GRADE AND NON-DIVIDEND PAYING SECURITIES.

One of plaintiff's three specific claims held by the trial court to have been waived is her right to claim damages because defendants purchased speculative, low grade and non-dividend paying securities for her account. 283 F.Supp. at 430.

Mrs. Hecht had no knowledge or understanding of securities from which she could meaningfully evaluate a security as speculative. As set forth above in the Statement of Facts and as the trial court expressly found (283 F.Supp. at 433), her understanding of securities was definitely limited and superficial. Her present investment advisor testified she had no understanding or even an awareness of the individual securities in her account in March 1964 and he has concluded she is not capable of managing her financial affairs (R.T. 1898-1900). Mrs. Hecht neither attempted to nor was she capable of evaluating the merits of securities purchased and sold for her account.

Further, *the confirmations and monthly statements* sent to plaintiff (Plaintiff's Exhibits 21A-21O), the exclusive documents relied upon by the trial court to establish waiver, did not place Mrs. Hecht in any better position to know that her account was being unsuitably managed. These documents *merely list the names of the company involved without indicating the type or quality of the security.* Mrs. Hecht relied upon Mr. Wilder to look after

her interests and accepted his every recommendation without challenge.

Nor did Mrs. Hecht know or have notice that many of the securities selected by Mr. Wilder did not pay dividends. Every month Mrs. Hecht received a check with a voucher attached marked merely "Dividends" without specifying the particular dividends included in the total amount (R.T. 2906-2908). The monthly statements sent to Mrs. Hecht were of no value in informing her which securities paid dividends because of Mr. Wilder's practice of taking the monthly statement from her shortly after its arrival. Although one who is capable of reading and understanding monthly statements (not an easy matter) can determine which securities paid dividends that month and in what amount, to determine whether a particular security issue pays a dividend and in what amount would require accumulating the monthly statements for the entire year as dividends are declared and paid at varying periods—quarterly, semi-annually or annually. *Since Mrs. Hecht never had more than one monthly statement in her possession at any one time, she had no means of determining whether her securities did or did not pay dividends.* She did not take down figures from the monthly statements while they temporarily were in her possession as *all of the bookkeeping regarding her accounts was performed by Mr. Wilder.*

Likewise, Mrs. Hecht had no knowledge or notice that overall her net dividend income was declining (Chart V, *supra*, p. 23). The monthly dividend check sent to plaintiff was for the gross amount of the dividends received the previous month without a deduction for the interest paid that month on the margin debit. By substantially increasing the margin debit (from \$46,000 when transferred to Harris, Upham & Co. in May 1957 to over \$200,000 on March 31, 1964—see Plaintiff's Exhibit 289), defendants were able to purchase and hold in the account such a large number of securities that even though many did not pay dividends, enough

did so that the gross dividend amount sent to Mrs. Hecht was sufficiently high to conceal her true income position.

Mrs. Hecht did not, therefore, have actual knowledge prior to March 1964 that her dividend income had virtually evaporated and that many of the securities purchased for her paid no dividend or were otherwise speculative and unsuitable for her. Without such actual knowledge Mrs. Hecht lacked that "full knowledge" which is a prerequisite to a finding of waiver.

3. PLAINTIFF CANNOT BE HELD TO HAVE WAIVED HER RIGHT TO CLAIM DAMAGES ARISING FROM THE PURCHASE OF COMMODITIES FOR HER ACCOUNT WITHOUT HER KNOWLEDGE OR COMPREHENSION AS TO THEIR SIGNIFICANCE OR SUITABILITY.

Similarly, plaintiff cannot be held to have waived her claim based upon the unsuitability of commodities transactions. 283 F.Supp. at 430. *The trial court found that Mrs. Hecht's comprehension of commodities was "virtually nil" and that her entry into commodities—upon Wilder's "encouragement and recommendation"—as a "relatively unsophisticated widow" in view of her need and objectives, was "remarkable."* 283 F.Supp. at 433, 435. These findings necessarily preclude finding that plaintiff comprehended the significance and suitability of commodities or that she had an appreciation of the risks they entail. Without actual knowledge of the risks and amounts involved by the commodity transactions, plaintiff cannot have waived her right to object to their suitability solely because she may have known there were commodities in her account.

Again, the documents noted by the trial court fail to apprise anyone, let alone plaintiff, of the risks involved in commodity trading or of its suitability for one in her circumstances. *The commodity monthly statements do not reflect the total price of commodities purchased and sold in the account. Nor do they set forth the potential profit or loss on commodities held in the account. The monthly statements are, therefore, misleading in that they do not reflect the customer's equity or true cash position at any time.*

Cf. *Newkirk v. Hayden, Stone & Co.*, CCH Fed. Sec. L. Rep., para. 91,621 (S.D. Calif. 1965); 17 C.F.R. § 240.10b-5(2).

Even the amounts consumed by the commodity account losses were unknown to plaintiff prior to March 1964. As transfers of funds were repeatedly made in both directions between the securities and commodities accounts, only detailed bookkeeping encompassing the life of the account revealed that transfers in excess of \$245,000 were made from the securities to the commodities account to cover the total commodity losses of \$176,000. Again, Mrs. Hecht lacked the ability to keep such records, made no attempt to, and was even denied the underlying data necessary for such computation by Mr. Wilder's practice of regularly removing from her possession all the papers sent to her by Harris, Upham & Co.

Further, to meet the test of waiver established by the *Smith* case, it would need to be shown that plaintiff knew and understood that civil liability existed for commodity transactions, a legal conclusion still hotly disputed by defendants.

4. MRS. HECHT DID NOT WAIVE HER RIGHT TO DAMAGES BECAUSE OF THE SHORT SALES EFFECTED FOR HER ACCOUNT BY DEFENDANTS (283 F.SUPP. AT 430).

Nothing in the record substantiates that Mrs. Hecht was aware that a short sale differed from a long sale or that she understood the greater risks inherent in short transactions. Although the monthly statements listed the short security transactions separately, they gave no information to plaintiff indicating the impropriety of these transactions for her. Further, plaintiff could not have even determined the amount of loss sustained on these transactions (over \$10,000) as she did not have in her possession at any time the monthly statements reflecting both sides of the short transactions. It cannot, therefore, be held that the information available to plaintiff from the account documents or elsewhere was sufficient to make known to her the losses from and impropriety of such

short transactions or to inform her that she could claim damages under the Securities Exchange Act because of these transactions.

Only after proof that Mrs. Hecht had vastly greater actual knowledge than she in fact did, could it be said that she waived any of her claims under the Securities Exchange Act. *Her mere acquiescence without understanding does not measure up to the standard of "intentional conduct" required for the establishment of waiver by this Court in Smith, nor conform to the Congressional intent to restrict waivers of the protections afforded the investing public by the Federal Securities laws.*

5. MRS. HECHT DID NOT WAIVE DAMAGES ARISING FROM DEFENDANTS' FAILURE TO MANAGE HER ACCOUNT AS AN INVESTMENT ACCOUNT.

Based upon its holding of waiver of these three specific claims, the trial court holds that plaintiff waived her right to claim damages arising from defendants' failure to manage her account as an investment account because she "knew" of the true manner of its management.

There is, however, nothing in the record indicating that plaintiff could distinguish a "trading" from an "investment" account or that she "knew" her account was being managed—as defendants admit—as a trading account (R.T. 470). To the contrary, it is evident that plaintiff was at best optically aware that slips of paper were being received without mental comprehension of their contents.

It is necessary to distinguish between the quantitative and the qualitative understanding of the customer:

"Defendants further assert that plaintiff's right to recover is barred by her ratification of the transaction and by her laches. They rely on the doctrine that an allegedly defrauded customer cannot stand by and speculate on the market, ratifying the transaction if it is to his advantage, and disaffirming it if it produces a loss. . . . *The application of this principle presupposes that the victim knows of his right to disaffirm.* The evidence shows that by phone conversations, confirmation slips and monthly accounts, plaintiff was apprised of what was being done in her account; and that she

was able to keep her own records of these transactions. *This quantitative appreciation of the disposition being made of her resources might justify, but it does not compel, a finding that she was aware of the lack of suitability of her investments, or of the impropriety of the manner in which her account was being handled. The evidence supports the conclusion, inherent in the court's findings, that she was unaware of the qualitative nature of the transactions recommended by her advisor. The court properly found: '13. That the plaintiff was not guilty of contributory negligence.'* "

Twomey v. Mitchum, Jones & Templeton, Inc., 262 A.C.A. 759, 799 (1968) (emphasis added)

The number of slips in plaintiff's possession prior to their being taken by Mr. Wilder weekly or more often was insufficient to put her on notice that the account was not being handled as her previous Walston & Co. account, i.e., as an investment account. An investment account does not imply a total absence of activity. That more slips of paper were now being received than from Walston & Co. was to be expected because of the vastly increased (over twelve times) value of the account. Nor did Mrs. Hecht comprehend the significance of many of the papers received, unsuccessfully seeking an explanation of them from Mr. Wilder.

For a fuller treatment of this point, see Plaintiff's Memorandum of Corrections and Comments on Hearing of October 20, 1967 and Reply to Defendants' Comments on Said Hearing, C.T. 870-875.

Plaintiff was gullible, as was Dr. Smith, and may even have been negligent in not seeking assistance. She was overtrusting in relying on Mr. Wilder and his false summaries of account, although this is understandable in view of her personality and her physical and mental difficulties. Certainly it should not be said that a lonely and elderly widow without business experience has lost her right of recovery when Dr. Smith, a professional male of good physical and mental health, did not waive his rights by failing to repudiate a transaction even after the matter had been partially investigated by his attorney.

PLAINTIFF WAS ENTITLED TO DAMAGES BASED UPON A COMPARISON OF THE RESULTS OF THE ACTUAL MANAGEMENT OF HER ACCOUNT WITH THE RESULTS WHICH WOULD HAVE BEEN OBTAINED HAD HER ACCOUNT BEEN PROPERLY MANAGED.

The trial court awarded plaintiff only certain damages caused by the churning of her account and denied her damages based upon a "loss of bargain" theory as measured by comparing the actual management of her account with the proper management of it as an investment account.

A.

THE MEASURE OF DAMAGES TO BE APPLIED IS THAT WHICH WILL MAKE PLAINTIFF WHOLE.

The measure applied by the trial court is at odds with the basic and long-established principle of measuring damages—that the plaintiff be made whole.¹⁴

"Compensation is the fundamental and all pervasive principle governing the award of damages. Compensation, not restitution, value, not cost, is the measure of relief. Whether the action be ex contractu or ex delicto, the end in view is the same,—that plaintiff be made whole."¹⁵

Plaintiff is entitled to recover for all of the damages she has sustained resulting from defendants' tortious conduct:

"For the breach of an obligation not arising from contract, the measure of damages . . . is *the amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not.*"

California Civil Code § 3333 (emphasis added)

14. *Zikratch v. Stillwell*, 196 Cal.App.2d 535, 543 (1961) ("the criteria is what amount will reasonably compensate plaintiffs for the injury they suffered.")

15. William B. Hale, *Handbook on the Law of Damages*, (2nd Ed. by Roger W. Cooley, 1912), pp. 4-5. See also, 22 Am.Jur.2d *Damages*, p. 28.

B.

MRS. HECHT WAS NOT MADE WHOLE BY THE DAMAGES AWARDED.

Had Mrs. Hecht's account been properly handled by defendants as an investment account, she would not have suffered the following detriments:

1. The payment of the \$232,000 paid to Harris, Upham & Co. as commissions, mark-ups and interest, plus the payment of an additional \$7,900 in transfer taxes and charges. The transfer taxes and charges are discussed *infra* at p. 54.
2. The further loss on commodity transactions of \$78,000 (overall loss of \$176,000 less commissions paid of \$98,000 included above).
3. The loss of dividend income she would have received had her account been properly managed.
4. The loss arising from the conversion of the Itek and Colonial securities.
5. The payment of \$57,000 in Federal and \$7,000 in California income taxes on securities and commodities transactions.
6. The decline in value in her account and the loss of capital appreciation the account would have experienced under proper management.

Although the trial court awarded damages for items 1 (excepting the transfer taxes and charges), 2, 3 and 4, it declined to award damages for items 5 and 6. Plaintiff contends that to be made whole she is entitled to compensation for each and all of these items, exclusive of any duplication of damages.

C.

**PLAINTIFF'S DAMAGES ARE TO BE MEASURED BY COMPARING
THE ACTUAL MANAGEMENT OF THE ACCOUNT WITH THE
RESULTS OBTAINABLE FROM PROPER MANAGEMENT.**

In the circumstances of the present case, the appropriate measure which encompasses all of the damages sustained is a comparison of what actually happened with what would have happened had the account been properly managed.

The most extended and comprehensive discussion to be found regarding damages in churning cases appears in *Churning by Securities Dealers*, 80 Harv. L. Rev. 869 (1967). It is there stated that although exactitude in determining damages caused by churning may be difficult, in theory the plaintiff is to be compensated for "the difference between what he would have had if the account had been handled legitimately and what he actually did have." 80 Harv. L. Rev. at 883.

It is this measure which also has been recently stated by a California appellate court decision to be most appropriate in a churning case:

"The most rational approach in a case of this nature may well be a comparison of the actual experience with a theoretical properly managed account." *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 A.C.A. 759, 802 (1968).

The Harvard Law Review article discusses three possible means of computing damages so as to make the plaintiff whole. The first, that of requiring the return of profits or commissions earned by the dealer, is not appropriate where the losses exceed the commissions paid and is criticized for bearing "no rational relationship to the amount of harm done to the customer". 80 Harv. L. Rev. at 884.

A similar criticism has been made of this measure by a California appellate court:

"Such a rule would allow a stockbroker to fraudulently induce his clients to buy a certain stock and escape liability in damages, except for the amount of the commission, by simply showing that, *at the time of the purchase*, 'the actual value of that which he received' was equal to 'that with which the defrauded person parted.' We do not think that this should be the law." *Walsh v. Hooker & Fay*, 212 Cal.App.2d 450, 461-462 (1963).

The second means proposed is the one historically used by the Securities Exchange Commission and the NASD (see Plaintiff's

Exhibits 271,271A)—a comparison of the “customer’s final position” with “the position he would have been in had there been no trading at all.” 80 Harv. L. Rev. at 885. This means is to be utilized when a “hands off” approach is justified by the facts of the particular case.

The third means, and that preferred by the authors of the article, is to award the plaintiff “the profits that a properly managed account would have yielded.” 80 Harv. L. Rev. at 885. The article suggests that this computation be based upon one of the indices for market prices generally, or, alternatively, on the interest rate applied to judgments or another rate. The index used should vary with the type of account so that “an account trading in blue chip stocks might be more appropriate for use of the Dow-Jones average than one trading in unlisted securities.” 80 Harv. L. Rev. at 885. The use of a general market index is specifically recommended for use when there has been a market decline.

D.

THE DAMAGES CAUSED BY DEFENDANTS’ FAILURE TO MANAGE PLAINTIFF’S ACCOUNT AS AN INVESTMENT ACCOUNT ARE BEST COMPUTED ON THE BASIS OF PROJECTING FORWARD THE ORIGINAL PORTFOLIO.

Plaintiff contends that her loss of bargain (i.e., the comparison of proper management with the actual management) is here most appropriately computed by using the projected value of the initial portfolio. Plaintiff turned over to Harris, Upham & Co. an exceptionally high quality portfolio consisting almost entirely of dividend paying blue chip securities. Her stated desires and her needs as an elderly widow with no other source of income were to preserve these securities and their substantial dividend income. These securities, if maintained, would have risen in value by March 31, 1964 to \$1,026,775, in comparison to an actual value of the account at that time of \$251,308, a difference of \$775,462. Further, these securities would have provided an annual dividend income of between \$26,000 and \$32,000 in comparison to actual annual net dividend income received of from \$4,000 to \$17,000, a

difference in net dividend income for the life of the account of over \$108,000 (Plaintiff's Exhibit 282).

These figures illustrate the detriment sustained by plaintiff because of defendants' improper and unsuitable handling of her account. Although plaintiff has not and does not contend that there should have been a complete "hands off" policy under proper management, there are here compelling reasons for using the projected value to compute damages. Because of the quality of her initial portfolio, few changes would have been called for had it been properly managed. Secondly, Harris, Upham & Co. holds itself out as an expert in investment affairs, possessing "experience, skill, research and organization" to create investment plans objectively based on the needs of the individual (Plaintiff's Exhibit 219; see Plaintiff's Trial Memorandum of Fact, C.T. 596-599). It is, therefore, reasonable to assume that at least some of the changes which might properly have been made *would have improved plaintiff's position*. Projecting forward the value of the original portfolio considers all of the securities in the original portfolio—those which declined or appreciated little in value as well as those which greatly appreciated. The standard plaintiff contends should here be applied is, therefore, a conservative standard—a standard below that which Harris, Upham & Co. sets for itself.

Although this means of computing the results of proper management is most appropriate for the reasons stated, alternative means of computation exist. First, *between the end of April 1957 (when plaintiff's portfolio was turned over to Harris, Upham & Co.) and March 31, 1964 (when the account was transferred out), the Dow Jones industrial list rose 165% while during the same period the Standard & Poor's 500 stock average rose 170%. This period showed one of the greatest advances in the history of the stock market* (R.T. 1906).

When applied to the original value of plaintiff's portfolio of \$533,161, these indices result in final values for the account of

\$879,715 and \$906,373 respectively, which is \$628,407 and \$655,065 more than the actual ending value of \$251,308.

The California legal rate of interest on judgments of 7% when applied to the initial portfolio value of \$533,161 and compounded annually for a period of six years and eleven months (the life of the account) gives an ending value of \$851,539 for the account, which is \$600,231 more than its actual value on March 31, 1964.

Nor is it appropriate to reduce the damages computed by this measure by the amount of capital withdrawals from the account except to the extent of \$9,000.

Although there was a net capital withdrawal from plaintiff's account at Harris, Upham & Co. of about \$88,000, of this amount \$64,000 was used by plaintiff to pay income taxes on the gains occurring from security and commodity transactions and a further \$15,000 was withdrawn to purchase the Colonial shares thereafter converted by Mr. Wilder. These withdrawals would not have been necessary had plaintiff's account been properly managed and should not, therefore, enter into this calculation of damages.

As the trial court found, proper management of the account also would have resulted in plaintiff's receiving substantially greater dividend income than that actually received. Plaintiff introduced exhibits based upon the original portfolio (Plaintiff's Exhibits 281, 282) establishing that this additional dividend income would have been between \$70,000 and \$108,000. The trial judge awarded damages for the loss of dividend income in the amount of \$65,000 and plaintiff is entitled to recover for this detriment in at least that amount.

Further, plaintiff is to be compensated for the Itek and Colonial conversions, in accordance with the findings and award of the trial court.

Compensation for these three items (i.e. loss of growth, loss of dividend income and conversion of Itek and Colonial shares) will encompass the other items of detriment earlier listed—commissions and interest paid, commodity losses, and income taxes paid—

and will place plaintiff in the position she would have been in March 1964 but for defendants' improper and fraudulent conduct. It is in this position that plaintiff is entitled to be placed by the award of damages.

E.

THE MEASURE OF DAMAGES APPLICABLE TO A BREACH OF FIDUCIARY DUTY ALSO REQUIRES THAT PLAINTIFF BE AWARDED DAMAGES FOR THE FULL AMOUNT OF HER LOSSES.

The District Court held that defendants had acted improperly as a "fiduciary" by "clearly and unfairly" transgressing "reasonable limits" in the handling of plaintiff's account. 283 F.Supp. at 440. The finding that defendants occupied a fiduciary position in relation to plaintiff is in accord with the general principle that stockbrokers are fiduciaries. See *infra*, pp. 56-57.

The principle of damages applicable in cases involving a breach of fiduciary duty—which breach plaintiff alleged as a pendent claim—is compensation for all detriment proximately caused the plaintiff, whether it could have been anticipated or not. California Civil Code § 3333.

A recent California decision notes that through the cases involving breaches of fiduciary duty "runs one common thread—a determination that the faithless fiduciary shall make good the full amount of the loss of which his breach of faith is a cause." *Prince v. Harting*, 177 Cal.App.2d 720, 730 (1960). See also, *Foster v. Keating*, 120 Cal.App.2d 435, 443 (1953) (For breach of fiduciary duty the plaintiff is entitled to recover all "damages and losses sustained" by "reason of defendant's misconduct.")

The California courts are particularly solicitous of the plaintiff in awarding damages when the defendants have abused a fiduciary relationship. *Walsh v. Hooker & Fay*, 212 Cal.App. 2d 450, 461 (1963); *Menefee v. Oxnam*, 42 Cal.App. 81, 87-88 (1919); *Purviance v. Shostak*, 90 Cal.App. 2d 295, 297 (1949).

When a trustee breaches his trust he is held to the standard of due care and proper management:

" . . . it is settled law that a violation by a trustee of a duty which equity lays upon him, whether willful and fraudulent or done through negligence, or arising through mere oversight or forgetfulness, is a breach of trust (3 Pomeroy's Equity Jurisprudence, sec. 1079), *and he may be charged with rents, profits, interest, income, proceeds of sales, and the like, which he never in fact received, but which he might and should have received by the exercise of due and reasonable care, diligence, and prudence in his modes of dealing.* (Pomeroy's Equity Jurisprudence, sec. 1070.)" *Gaver v. Early*, 58 Cal.App. 736, 737 (1923) (emphasis added).

See also, *Estate of Talbot*, 141 Cal.App. 2d 309, 310, 320-327 (1956)

Erickson v. Boothe, 127 Cal.App.2d 644, 648-650 (1954)

The principle enunciated by these California cases coincides with that which plaintiff contends applies to her claims under the Federal Securities laws—that she is entitled to be awarded damages based upon what she might have received "by the exercise of due and reasonable care, diligence, and prudence" by defendants as brokers holding themselves out as experts in the field of investments.

III

PLAINTIFF SUFFERED ITEMS OF DAMAGE BECAUSE OF THE CHURNING OF HER ACCOUNT FOR WHICH SHE WAS NOT COMPENSATED.

Even accepting the trial court's position that plaintiff is limited to claiming only those damages arising from the churning of her account, not all the damages proximately caused by that churning are included in the trial court's award.

A.

PLAINTIFF IS ENTITLED TO BE COMPENSATED FOR INCOME TAXES PAID ON SECURITIES AND COMMODITIES TRANSACTIONS.

The trial court did not include in its damage award any of the \$64,000 it found plaintiff paid in federal and state income

taxes on the gains arising from the securities and commodities transactions.

Such capital gains taxes paid are properly awarded in churning cases. *Stevens v. Abbott, Proctor & Paine*, CCH Fed. Sec. L. Rep., para. 92,257 (E.D. Va. 1968), pp. 97,238-97,239. Capital gains taxes have also been awarded where a trustee improperly sold stocks from the trust. *Estate of Talbot*, 141 Cal.App. 2d 309, 310, 320-327 (1956).

To the extent that such taxes were paid on the "excessive" transactions found by the trial court, they represent another element of damages proximately caused by and attributable to defendants' churning of plaintiff's account.

Capital gains were not in plaintiff's best interests as they forced her to withdraw capital from her account to pay taxes on the resulting gains. To the extent that the gains were not withdrawn for taxes, they remained in the account and were utilized by defendants to further churn the account.

The trial court found (283 F. Supp. at 425) that only \$24,000 was withdrawn by plaintiff from capital for other than the payment of taxes in the seven years her account was at Harris, Upham & Co. This figure *includes* the \$15,000 withdrawn to purchase the 120 shares of Colonial Savings and Loan converted by Mr. Wilder, and does not consider the vastly impaired dividend income received on the account caused by defendants' improper management. The amount withdrawn by plaintiff for her own use was, therefore, minimal and the continual sale of securities by defendants cannot be justified by any interest of plaintiff.

It is apparent, therefore, that the income taxes of \$64,000 paid on the securities and commodities transactions were the proximate result of the churning. Had the account not been excessively active, there would have been far fewer transactions and far fewer gains upon which to pay taxes.

As to the claim that part of these taxes were on non-excessive transactions, since the defendants are responsible for the loss they

are chargeable with the entire amount for failing to affirmatively establish that part which was not caused by their improper activity. *Gratz v. Claughton*, 187 F. 2d 46, 51-52 (2d Cir. 1951).

B.

TRANSFER TAXES AND CHARGES SHOULD ALSO BE AWARDED.

Plaintiff additionally paid as a result of the excessive activity in her account, \$7,900 in federal, state and SEC transfer taxes and charges. Although this figure was not presented to the trial court, it has since been computed by plaintiff's counsel from the confirmation slips sent to plaintiff (Plaintiff's Exhibits 21B, 21D, 21F, 21H, 21J, 21L, 21N and 21O). It is an item of damage comparable to the commissions paid by plaintiff to Harris, Upham & Co. and awarded by the trial court which were listed on and computed from the same confirmation slips. Transfer taxes paid by a customer were recently awarded in a churning case. *Stevens v. Abbott, Proctor & Paine*, CCH Fed. Sec. L. Rep., para. 92,257 (E.D. Va. 1968), p. 97,239.

C.

THE LOSS OF GROWTH IN THE VALUE OF PLAINTIFF'S ACCOUNT IS ATTRIBUTABLE TO THE CHURNING OF THE ACCOUNT.

Finally, that plaintiff did not participate in the general growth in the value of securities occurring while her account was held by Harris, Upham & Co. is also attributable to defendants' churning of her account. In view of the high quality of the securities turned over to Harris, Upham & Co., these securities if left intact, would have nearly doubled in value while securities values in general rose substantially between May 1957 and March 1964. See *supra*, p. 22.

Because defendants churned plaintiff's account, securities which would have substantially appreciated in value were sold and the proceeds used to purchase speculative commodity futures and to purchase securities which declined in value or appreciated to a lesser degree than those originally owned by plaintiff.

If only a proper number of transactions had been effected and plaintiff thereby left with all or virtually all of her original portfolio, her account would have been of vastly greater value in March 1964 than it was in fact. *The excessive purchases and sales prevented Mrs. Hecht from retaining her original portfolio and from sharing in the benefits of a rising market. This is an additional detriment suffered by her and for which she is entitled to compensation.*

IV

**PLAINTIFF WAS ENTITLED TO AN AWARD OF DAMAGES
BASED UPON HER PENDENT CLAIM THAT DEFENDANTS
BREACHED THEIR FIDUCIARY DUTIES AND RESPONSIBILITIES
OWED TO HER UNDER THE LAWS OF CALIFORNIA.**

In her complaint, and ever since its filing, plaintiff has asserted a pendent claim for damages based upon the California law regarding the duties and obligations of fiduciaries. See generally, 23 Cal. Jur.2d, *Fraud and Deceit*, pp. 9-21. The factual basis for this claim was the same evidence introduced in support of the violations of the Federal Securities laws which the trial court found had occurred. Such state and federal claims arising out of the same core of facts are properly joined in a single federal court action.

Matheson v. Armbrust, 284 F.2d 670, 673-674 (9th Cir. 1960)

Globus v. Law Research Service, Inc., CCH Fed. Sec. L. Rep., para. 92,226 (S.D. N.Y. 1968), p. 97,050

United Mine Workers v. Gibbs, 383 U.S. 715, 721-729 (1966)

Moran v. Paine, Webber, Jackson & Curtis, 279 F.Supp. 573, 577 (W.D. Pa. 1967), aff'd 389 F.2d 242 (3rd Cir. 1968)

Although the trial court recognized that plaintiff asserted a claim based upon a breach of fiduciary duty under the law of

California and found that defendants had "clearly and unfairly transgressed reasonable limits" in the handling of plaintiff's account as a "fiduciary" (283 F.Supp. at 427, 439-440), it did not expressly rule upon plaintiff's pendent common law claim. Because of its bearing upon the applicable measure of damages (see *supra*, pp. 51-52) plaintiff was entitled to a ruling upon her pendent claim and an award of damages based upon it.

A.

STOCKBROKERS OCCUPY A FIDUCIARY POSITION IN RELATION TO THEIR CUSTOMERS.

Stockbrokers in general are fiduciaries and are required to adhere to a high state of honesty and morality in transactions with their customers.¹⁶

Regardless of any special reliance or dependence by the customer on the broker, as was present in this case, a stockbroker has a duty to treat all customers fairly because he holds himself out as a professional possessing specialized knowledge and technical skills and he cultivates customers' trust and confidence.¹⁷

California courts have repeatedly recognized that stockbrokers are fiduciaries.

Twomey v. Mitchum, Jones & Templeton, Inc., 262 A.C.A. 759, 778 (1968):

"The relationship between broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith towards the principal."

16. *Smith v. Bear*, 237 F.2d 79, 87-88 (2d Cir. 1956); *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 436-437 (2d Cir. 1943); *Opper v. Hancock Securities Corp.*, 250 F.Supp. 668, 676 (S.D.N.Y. 1966); Article III, Section 1, NASD Rules of Fair Practices; 3 Loss, *Securities Regulation*, pp. 1482-1489.

17. See generally, Leavell, *Investment Advice and the Fraud Rules*, 65 Mich. L. Rev. 1569, 1579-1595 (1967); Mundheim, *Professional Responsibilities of Broker-Dealers, The Suitability Doctrine*, 1965 Duke L.J. 445; Loomis, *Enforcement Problems Under the Federal Securities Laws*, 14 Business Lawyer 665, 674-675 (1959).

Blackburn v. Dean Witter & Co., 201 Cal. App. 2d 518, 523 (1962)

Walsh v. Hooker & Fay, 212 Cal.App.2d 450, 453 (1963)

Cf. Witkin, *Summary of California Law*, "Agency and Employment," Sec. 26, p. 404 (1960)

Here, the special and unique relationship between Mr. Wilder and Mrs. Hecht makes indisputable the existence of a fiduciary relationship. There can be no question of the absolute and total control exercised by Mr. Wilder over Mrs. Hecht and her account and her reliance upon him to handle her financial affairs.

B.

UNDER THE LAW OF CALIFORNIA PLAINTIFF IS ENTITLED TO DAMAGES ARISING FROM DEFENDANTS' FAILURE TO MANAGE HER ACCOUNT AS AN INVESTMENT ACCOUNT.

Where a confidential relationship exists, full and complete information respecting the subject of dealings between the parties must be given by the trusted party and any concealment, misrepresentation or breach of duty on his part is actionable fraud.

Calif. Civil Code § 1573

Stevens v. Marco, 147 Cal.App.2d 357, 378 (1956)

Barron Estate Co. v. Woodruff Co., 163 Cal. 561, 576 (1912)

("[B]y virtue of this agency and relationship of trust and confidence, it became the high duty of defendants to make full disclosure of all the knowledge which they possessed and which it was desirable or important that their principal should have.")

Under California law, the one in whom trust and confidence is reposed has the burden of showing fairness and the utmost good faith in all his dealings with the confiding party and also must show that he has not abused the confidence by obtaining any advantage to himself at the expense of the confiding party.

Calmon v. Sarraille, 142 Cal. 638, 641 (1904)

Devers v. Greenwood, 139 Cal.App.2d 345, 348 (1956)

Cox v. Schnerr, 172 Cal. 371, 378-379 (1916)

Johnson v. Clark, 7 Cal.2d 529, 534-535 (1936)

California law also *presumes* that he who holds the confidence of another exercised it unduly to his own advantage unless it is shown that the confiding party had independent advice, that his action was the result of his own volition, and that he both understood the act and comprehended its effect.

Ross v. Conway, 92 Cal. 632 (1892)

Walker v. Smith, 58 Cal. App. 145, 150-153 (1922)

Rieger v. Rich, 163 Cal.App.2d 651, 663-666 (1958)

Chung v. Johnston, 128 Cal.App.2d 157, 164 (1954)

In contrast to these high standards required of a stockbroker as a fiduciary, defendants not only failed to act with Mrs. Hecht's interests as the uppermost consideration, but intentionally acted directly contrary to her interests by converting her securities and misappropriating her assets by churning her account.

It is clear that plaintiff neither understood what defendants were doing with her account nor did she have any independent advice regarding her securities. Defendants have, therefore, breached the fiduciary duties and responsibilities they owed to plaintiff and, as a result, plaintiff has been severely damaged—entitling her to full compensation. *Had defendants looked first to plaintiff's interests, the account would have been managed as an investment account. Accordingly, Mrs. Hecht is entitled to the damages arising from defendants' failure to so manage her account.*

Since the trial court's decision, an important California appellate decision has been rendered which sets forth in detail the high standards required of stockbrokers under California law.

Twomey v. Mitchum, Jones & Templeton, Inc., 262 A.C.A. 759 (1968)

The Twomey decision makes clear that plaintiff possesses a valid claim against defendants under the law of California for their failure to properly manage her account as an investment account and that she is entitled to recover damages based upon a compari-

son of the actual management of the account with its proper investment management. Plaintiff respectfully directs the Court's attention to this significant decision.

V

PLAINTIFF IS ENTITLED TO DAMAGES ARISING FROM DEFENDANTS' VIOLATIONS OF THE SUITABILITY RULE.

Section 2 of Art. III of the NASD Rules of Fair Practice provides:

"In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

It is this rule which plaintiff contends establishes a standard of conduct for securities brokers, the violation of which gives rise to civil liability. The trial court has held to the contrary. 283 F.Supp. at 430-431.

A.

THE NASD RULES OF FAIR PRACTICE ARE AN INTEGRAL PART OF THE CONGRESSIONAL SCHEME FOR REGULATION OF THE SECURITIES INDUSTRY.

The primary purposes of Congress in enacting the Securities Exchange Act of 1934 were "to protect the general investing public" (*Baird v. Franklin*, 141 F.2d 238, 244 (2d Cir. 1944) (opinion of Clark, J., dissenting in part)) and to "achieve a high standard of business ethics in the securities industry." *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).¹⁸

This Court has recognized that the end sought by the Securities Exchange Act of 1934 was "the lessening of fraudulent and sharp

18. See generally, Philip A. Loomis, Jr., *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 Geo. Wash. L. Rev. 214 (1959).

practices in the securities market." *Fratt v. Robinson*, 203 F.2d 627, 631 (9th Cir. 1953) (emphasis added). See also, *Errion v. Connell*, 236 F.2d 447, 454 (9th Cir. 1958).

Pursuant to these purposes, Congress amended the Securities Exchange Act in 1938 to provide in Section 15A (15 U.S.C.A. § 78o-3) for the formation of national securities associations under the general and direct supervision of the SEC. *The NASD is the only national securities association registered under this provision and as such is "a creature of statute" which "is primarily engaged in regulatory activities."*¹⁹

This means of protecting the investing public was intentionally selected rather than the alternative means of expanding the SEC:

"The committee believes that there are two alternative programs by which this problem could be met. *The first would involve a pronounced expansion of the organization of the Securities and Exchange Commission . . . and a minute, detailed, and rigid regulation of business conduct by law. . . . The second of these alternative programs, which the committee believes distinctly preferable to the first, is embodied in S. 3255. This program is based upon cooperative regulation, in which the task will be largely performed by representative organizations of investment bankers, dealers and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation.*"²⁰

A registered national securities association is *required to adopt rules designed "to prevent fraudulent and manipulative acts and*

19. *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4 at 603 (1963) (emphasis added). See generally, Weiss, *Registration and Regulation of Brokers and Dealers* (BNA 1965), ch. 24; Marc. A. White, *National Association of Securities Dealers, Inc.*, 28 Geo. Wash. L. Rev. 250 (1959).

20. S. Rep. No. 1455, 75th Cong., 3d Sess. 3-4 (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess. 4-5 (1938) (emphasis added).

practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest." 15 U.S.C.A. § 78o-3(b) (7) (emphasis added). The association *must discipline its members for violation of these rules*. 15 U.S.C.A. § 78o-3(b) (8).

No applicant association is to be registered by the SEC unless the association has such rules (15 U.S.C.A. § 78o-3(b)) and the SEC is authorized to *abrogate, alter or supplement the rules of the association*. 15 U.S.C.A. § 78o-3(k).

The suitability rule set forth above is one of the Rules of Fair Practice adopted by the NASD (under its Congressional mandate) which the SEC has found are "directed toward eliminating abuses which might well lead to the defrauding of investors." *National Association of Securities Dealers, Inc.*, 5 SEC 627, 631 (1939). In light of the legislative background, this rule is a substitute for an SEC rule and should provide investors with the same rights as do SEC rules and regulations.²¹

B.

IMPLIED RIGHTS OF ACTION ARE AN IMPORTANT PART OF THE FEDERAL SECURITIES LAWS.

Implied rights of action for violations of the Federal Securities laws and rules promulgated thereunder are well known.²² Their value and significance have been strongly endorsed by this Court:

"We can think of nothing that would . . . more certainly tend to deter fraudulent practices in security transactions and thus make the [Securities Exchange] Act more 'reasonably complete and effective' than the right of defrauded sellers or buyers of securities to seek redress in damages in federal courts."

21. For further details of the legislative history and background, see Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules*, 51 Cornell L. Q. 633, 633-643 (1966).

22. See generally, Walter P. North, *Implied Liability Cases Under the Federal Securities Law*, 4 Corp. Prac. Comm. 1 (1962).

Fratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953)
(emphasis added)

See also, *Matheson v. Armbrust*, 284 F.2d 670, 674 (9th Cir. 1960).

Private rights of action for damages have been implied by this Court to give "*controlling weight to what seems to have been the dominant policy of Congress to provide complete and effective sanctions, public and private, with respect to the duties and obligations imposed under the [Securities Exchange and Securities] acts.*"

Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961) (emphasis added)

The United States Supreme Court has recently adopted the same position as this Court respecting implied rights of action under the Federal Securities laws.

J. I. Case Co. v. Borak, 377 U.S. 426, 430-435, 84 S.Ct. 1555, 1559-1561, 12 L.Ed. 2d 423 (1964)

The present Chairman of the SEC has also strongly endorsed private rights of action as a necessary means of policing the securities industry:

"The courts' willingness to imply a right of action to persons, for whose benefit Rule 10b-5 and other provisions of the securities laws were adopted, is a happy and healthy development.

"... I view the private right of action as important, if not indispensable, for a number of reasons. First, as a practical matter, the Commission could not have initiated all the suits which have reached the Courts of Appeals in recent years. We just don't have the manpower. As is true with much of our work, we rely on other people and institutions to assist in the enforcement and development of the securities laws. ... It seems almost embarrassing to find it necessary to argue, from time to time, that proper redress of private

wrongs must not be denied because of the inadequacy of our resources or because of our unwillingness, for any reason, to champion every cause.

"Indeed, *the existence of the private right of action enables the Commission to make a more substantial contribution to the growth of the law of corporate responsibility than it could otherwise.* Whatever expertise we have, we offer through our *amicus curiae* participation in cases which we or the courts believe particularly significant."

Manuel F. Cohen, *The Development of Rule 10b-5*, 23 Business Lawyer 593, 596-597 (1968) (emphasis added)

C.

THE SUITABILITY RULE IS AN APPROPRIATE RULE FOR THE IMPLICATION OF A PRIVATE RIGHT OF ACTION.

The most extended judicial discussion of implied rights under the NASD Rules of Fair Practice appears in *Colonial Realty v. Bache & Co.*, 358 F.2d 178 (2d Cir. 1966), cert. denied, 385 U.S. 812 (1961). This decision was heavily relied upon by the trial court in denying plaintiff's claim based upon the suitability rule.

In *Colonial Realty*, Judge Friendly held that there was no implied right of action to recover for a violation of the NASD Rule of Fair Practice which requires its members to "observe high standards of commercial honor and just and equitable principles of trade." NASD Rules of Fair Practice, Art. III § 1.

In so ruling, however, Judge Friendly recognized that certain NASD rules could appropriately serve as the basis for an implied right of action:

"Implication of a private right of action may be suggested . . . from such considerations as the protection intended by the legislature and the ineffectiveness of existing remedies, administrative and judicial, fully to achieve that end." 358 F.2d at 181.

In making a decision as to a particular rule, Judge Friendly suggests that courts "look to the nature of the particular rule and its place in the regulatory scheme." 358 F.2d at 182.

The nature and place of the suitability rule are appropriate for implying a private right of action. The rule is part of the dominating Congressional purpose to lessen fraudulent and sharp practices in the securities markets and to provide effective private sanctions designed to achieve this end and to achieve a "high standard of business ethics in the securities industry." *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

D.

THE SUITABILITY RULE IS AN EXPLICIT AND CLEARLY DEFINED RULE WHICH WAS VIOLATED BY DEFENDANTS IN THEIR HANDLING OF PLAINTIFF'S ACCOUNT.

Contrary to the vague and ill defined limits which Judge Friendly found inherent in "just and equitable principles of trade" (358 F.2d at 182), *the limits of the suitability rule are clear. It requires a broker to have reasonable grounds for believing that recommendations made to a particular customer are suitable for that customer.* The application of the rule is limited to the specific situation where a broker makes a recommendation, and its command is explicit. Any fear that the implication of civil liability for a violation of the rule will extend federal law into uncharted and uncertain areas is unfounded.

Similarly without basis is the trial court's expressed concern (283 F. Supp. at 431) that implying civil liability under this rule will result in the courts second-guessing the market judgments of a broker and possibly finding him liable for fraud when he has acted in "good faith."

The suitability rule does not establish as a standard that the market judgment of the broker be in fact reasonable for the customer. What it does require is that the broker, on the basis of the information available to him, have reasonable grounds for

believing that his recommendation is suitable for the particular customer. One who in "good faith" makes a recommendation to a specific customer will of necessity have the reasonable grounds which satisfy the rule.

Harris, Upham & Co. itself recognizes that "suitability" goes beyond the question of market judgment, for its supervising policies require both the registered representative and the supervising manager of a branch office to make certain that only suitable recommendations are made to a customer (Plaintiff's Exhibit 13 (p. 1); R.T. 469-470, 473, 2139).

The NASD and the SEC have found the suitability doctrine definite enough to serve as the basis for disciplinary action against brokers without resorting to "second guessing" of market judgments.

Boren & Co., 40 SEC 217, 222 (1960)

Thomas Arthur Stewart, 20 SEC 196 (1945)

Powell & McGowan, Inc., SEC Securities Exchange Act Release No. 7302 (April 24, 1964) (Where high risk securities were recommended to a 79 year-old retired customer who lived alone.)

Gerald M. Greenberg, 40 SEC 133, 137-138 (1960) (Suitability rule violated where broker-dealer failed to inquire into and determine investment needs and objectives of his customer.)

Further, the proposed Rules under the California Corporate Securities Law of 1968 specifically require California broker-dealers to adhere to the suitability rule and, for failure to do so, severe criminal penalties may be imposed:²³

"260.218.2. Suitability of Recommendations. Any non-registered broker-dealer and any agent employed by such a broker-dealer who recommends to a customer the purchase,

23. Violation subjects the offender to up to 10 years in jail, a fine of \$10,000, or both. California Corp. Code § 25540.

sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker-dealer or agent."

The suitability rule is, therefore, something far more than a professional or ethical rule of guidance. It is a duty incumbent upon the stockbroker which is recognized by Harris, Upham & Co., by the securities industry, by the SEC, and by the law of California. If its violation can result in the imposition of disciplinary and even criminal sanctions, its violation should also result in the lesser, and often more effective, sanction of civil liability. Such liability has been impliedly recognized by at least one federal court. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bockock, 247 F.Supp. 373, 376-377, 380 (S.D. Tex. 1965).

The applicability of the suitability rule to the facts of the present case is evident. The NASD has found that the rule was violated by defendants in the handling of Mrs. Hecht's account. It has found that "each and every transaction, considered in relation to all other transactions and in relation to the account overall, was unsuitable." Appendix A, p. 21. The NASD further found that the sole act of "putting an elderly widow of failing faculties into non-income producing and speculative holdings [i.e., commodities and many of the securities] is itself an act of 'unsuitability' of such magnitude to require revocation." Appendix A, p. 21.

Defendants' improper management of the account goes far beyond the question of "market judgment" on a particular transaction. It involves a course of conduct over a number of years during which defendants recommended and effected commodities transactions, short transactions and the purchase of innumerable non-divided paying and speculative securities which they knew

were inappropriate for a widow needing dividend income and stability of principal. To *impose liability for this conduct is not to "second guess" a broker but to accept the only possible conclusion from the evidence—that defendants managed Mrs. Hecht's account without giving the slightest consideration to her needs and objectives.*

If a case arises involving a close question of whether a broker should or should not have made a particular recommendation, the courts are well equipped to handle such a situation. *This is not such a case, and speculation as to what might happen in a hypothetical fact situation should not preclude plaintiff from recovering for what did happen to her.*

It is admitted by defendants that plaintiff's account was managed as a trading account and no claim is advanced or made that such management was appropriate or suitable for one in Mrs. Hecht's circumstances. Had defendants properly and suitably managed plaintiff's account as an investment account, she would have participated in the general increase in the value of securities which occurred between 1957 and 1964 as well as receiving substantially greater dividend income than she did. Defendants' unsuitable recommendations and management prevented her from receiving these benefits, and she is entitled to compensation for the loss of these benefits by an award of damages.

VI

PLAINTIFF WAS ENTITLED TO AN AWARD OF PUNITIVE DAMAGES BECAUSE OF DEFENDANT'S FRAUDULENT AND IMPROPER CONDUCT.

"For the generality of men are naturally apt to be swayed by fear rather than by reverence, and to refrain from evil rather because of the punishment that it brings than because of its own foulness."

Aristotle, *Nichomachean Ethics*, bk. X, ch. 9 (translated by F. H. Peters, London, 14th Ed), p. 346

Although the trial court held that punitive damages could have been awarded in this case, it declined to do so because of its allowance of pre-judgment interest on a portion of the judgment, and because defendants "are subject to disciplinary proceedings before the National Association of Securities Dealers." 283 F. Supp. at 445.

These reasons, it is submitted, are insufficient and amount to an abuse of discretion when utilized to deny an award of punitive damages.

Pre-judgment interest was applied only to part of the total damages awarded—the \$232,000 paid by plaintiff to Harris, Upham & Co. in commissions and interest. Further, the partial pre-judgment interest is compensatory rather than punitive in nature in that it was calculated from March 31, 1964 to the date of judgment herein. Had this amount not been wrongfully taken from plaintiff, she would have been able to earn a return on it through its investment. The award of interest, therefore, only substitutes for what she would otherwise have earned on this amount. Finally, defendants have had the beneficial use of all of the funds wrongfully taken from plaintiff since even before March 1964. Having to pay interest on this amount merely forces them to repay *a part* of the profits they received on the funds *misappropriated from Mrs. Hecht*.

The *proceedings* against Harris, Upham & Co., Mr. Wilder and Mr. Mejia *before the NASD* had only reached the hearing stage at the time the trial court handed down its decision. At that time there was no certainty that a determination would be made nor any certainty that discipline would be imposed against defendants for their improper and fraudulent handling of Mrs. Hecht's account.

Since the District Court's decision, the NASD has disciplined defendants for violations of the NASD Rules of Fair Practice found to have occurred in the handling of Mrs. Hecht's account.

The decision of the NASD is attached hereto as Appendix A and is incorporated herein by reference.

Especially for a second offense (see *infra*, pp. 71-72), the censure and fine of \$50,000 imposed by that decision on Harris, Upham & Co. are, it is submitted, merely a "slap on the wrist" to a national firm of the stature of Harris, Upham & Co. having gross assets in excess of \$135 million.

"If the purpose of punitive damages is to punish and to act as a deterrent, a verdict which is not in such sum as to make itself felt upon an offender defeats that purpose. Unless it is of sufficient substance to 'smart,' the offender in effect purchases a right to libel another for a price which may have little or no effect upon him. Indeed, in such a situation a defendant, instead of being deterred from a repetition of his offense, may be encouraged to renew his assault." *Reynolds v. Pegler*, 123 F.Supp. 36, 41-42 (S.D.N.Y. 1954), *aff'd* 223 F.2d 429 (2d Cir. 1955), *cert. denied*, 350 U.S. 846 (1955).

See also, Comment, *Exemplary Damages Awarded for Breach of Fiduciary Duty*, 33 N.Y.U.L. Rev. 877, 880-881 (1958).

The conduct engaged in by defendants clearly calls for the imposition of substantial punishment so as to deter it and others from similar conduct. The NASD discipline is not likely to do so. Further, the imposition of even the light NASD sanctions can be indeterminably delayed by Harris, Upham & Co. through the use of appeals, first to the Board of Governors of the NASD, then to the SEC, and finally to the federal courts. An appeal to the NASD Board of Governors has already been instituted by Harris, Upham & Co.²⁴

24. Plaintiff has requested the Board of Governors to pay over to her the fines levied against defendants if and when the fines are collected. Such a payment to a customer is not provided for by the NASD rules and has never before, to the knowledge of plaintiff's counsel, been made by the NASD.

Punitive damages are appropriate for intentional violations of the Federal Securities laws. Note, *Measurement of Damages in Private Actions Under Rule 10b-5*, Wash. U. L. Q. 165, 168 (1968); Comment, *Churning By Securities Dealers*, 80 Harv. L. Rev. 869, 885 (1967).

It is here particularly appropriate that the judgment not be limited to compensatory damages for this requires Harris, Upham & Co.

"to do no more than return the money which [it] had taken from the plaintiff. In the calculation of his expected profits, the wrongdoer is likely to allow for a certain amount of money which will have to be returned to those victims who object too vigorously, and he will be perfectly content to bear the additional cost of litigation as the price for continuing his illicit business. It stands to reason that the chances of deterring him are materially increased by subjecting him to the payment of punitive damages." *Walker v. Sheldon*, 10 N.Y. 2d 401, 406, 223 N.Y.S.2d 488, 492, 179 N.E.2d 497, 499 (1961).

In addition to deterring fraud generally in the purchase and sale of securities, punitive damages "serve the desirable function, certainly in cases involving limited amounts of compensatory damages (such as that here) of insuring that victims of a scheme to defraud . . . will not find themselves without an effective legal remedy" for "[m]any defrauded investors fail to sue either because they are unaware of a misrepresentation or lack the funds to finance such expensive litigation." *Globus v. Law Research Service, Inc.*, CCH Fed. Sec. L. Rep., para. 92,226 (S.D.N.Y. 1968), pp. 97,049, 97,053 (emphasis added). Cf. Hornstein, *Legal Therapeutics: The "Salvage" Factor In Counsel Fee Awards*, 69 Harv. L. Rev. 658, 663, 682 (1956).

The preparation and presentation of this case required the expenditure of thousands and thousands of hours of counsels' and accountants' time—as well as the expenditure of many thousands

of dollars in costs and expenses. *It is one of the few such cases ever tried to a court*, and it affords a unique opportunity to set the standards of conduct for an entire industry and to make clear that the courts will not countenance fraudulent and improper conduct by brokers in the handling of customers' accounts.

It is particularly to be noted that *this is not a case "brought against people of prior impeccable reputation"* and thus cannot be considered in itself as a sufficient deterrent to any future similar conduct. *Stevens v. Abbott, Proctor & Paine*, CCH Fed. Sec. L. Rep., para. 92,257 (E.D. Va. 1968), p. 97,236 (emphasis added).

As the NASD has noted:

"... it is also appropriate to note that Harris, Upham was censured by this Committee in July 1958 for a lack of supervision in its San Francisco office. The Committee's action was affirmed by the Board of Governors. This discipline was imposed after the filing of a complaint on April 10, 1957, charging Harris, Upham, one of its registered representatives, and another firm with violations arising from the parking and interpositioning of securities owned by Harris, Upham.

"The position of Harris, Upham was that it was not an active participant in the transaction handled by its registered representative. The decision of this Committee responded as follows:

'A member firm of the Association cannot, of course, be expected to discover immediately every violation of the Rules of Fair Practice which is committed by its employees. In this case, however, the transactions were carried on over a period of time, and we are forced to the conclusion that a number of the transactions could have been prevented if proper standards of supervision had been followed by Harris, Upham.'

"Thus, Harris, Upham was especially placed upon notice by this Committee of the inadequacy of its supervision of its registered representatives in San Francisco at the very time Mr. Wilder first became employed and at the very time Mrs.

Hecht first became a customer of *Harris, Upham*. This special notice of inadequate supervision further highlights *Harris, Upham*'s failure to supervise Mr. Wilder, a new employee, adequately and his handling of Mrs. Hecht's account.

"... had adequate procedures and practices been in effect, the improper handling of Mrs. Hecht's account by Mr. Wilder would have been detected and would not have been permitted to continue for almost seven years." See Appendix A, pp. 30-31 (emphasis added).

The trial court erroneously excluded this evidence of the prior NASD censure (R.T. 4406-4410) and denied plaintiff's motion to reopen the case on the issue of punitive damages. The motion was filed after plaintiff discovered from the NASD decision that *Harris, Upham & Co.* had been disciplined by that body in 1958 with respect to the San Francisco office. The trial court's Memorandum of Decision denying plaintiff's motion to reopen the case is attached hereto as Appendix B. Plaintiff requests this Court to consider the papers submitted by plaintiff on this motion to the District Court, which papers are now part of the record on these appeals as the Third Supplement to the Clerk's Transcript, and to make its own ruling. See *Canadian Ingersoll-Rand Co. v. Peterson Products*, 350 F.2d 18, 27 (9th Cir. 1965).

Plaintiff was entitled to have all relevant and material evidence before the District Court prior to a determination being made on the issue of punitive damages. In fraud actions, such as this, a wide range is allowed in the introduction of similar acts of misconduct.

Lyon v. Hancock, 35 Cal.372,376 (1868)

Janisse v. Winston Investment Co., 154 Cal.App. 2d 580, 588 (1957)

The District Court's conclusion that the previous NASD censure would not be admissible to prove the *propriety* of the censure

confuses the question of proof of a similar act of misconduct with that of its effect. A similar act of misconduct may be established in any number of ways—by a judgment, by an admission, or by the testimony of a witness.

Foster v. Keating, 120 Cal.App.2d 435, 442, 447 (1953)
(testimony of witness)

Janisse v. Winston Investment Co., 154 Cal.App. 2d 580,
587-588 (1957) (similar misconduct proven by documents)

Plaintiff was entitled to prove the prior lack of supervision by Harris, Upham & Co. in its San Francisco office by any generally accepted means of proof. Certainly a censure by the NASD from which Harris, Upham & Co. did not appeal would be an acceptable means of proof—as also would be testimony from witnesses or admissions from defendants in the form of answers to interrogatories.

The trial court's ruling has denied plaintiff the opportunity to fully present all the evidence from which a decision on the issue of punitive damages might properly be made.

CONCLUSION AND RELIEF SOUGHT

The rights of the investing public require that securities brokers be held to a high standard of prudence and care in their dealings with customers. The complexities and intricacies inherent in this field present innumerable opportunities for taking advantage of the unsophisticated or even the relatively sophisticated. Misconduct by brokers can only be effectively detected and deterred if customers are assured of being fully compensated by the courts for the damages resulting from a broker's failure to meet his professional responsibilities.

As persons holding themselves out as possessing special abilities and competence regarding investments, and as persons to whom customers look for the proper management of their securities, it

is only equitable and just that brokers be held liable for their failure to use due care and prudence in the handling of accounts which they control. This standard, it is submitted, is to be applied as a part of the Federal Securities laws, the law of California relating to the obligations of fiduciaries, and the NASD suitability rule.

Plaintiff respectfully requests this Court to insure that she and other investors receive the full protections they need and have been granted by Congress and the courts by reversing the trial court's findings on the issue of estoppel, laches and waiver, and by holding that plaintiff is entitled to recover damages based upon what she would have had under proper and suitable investment management of her account.

Respectfully submitted,

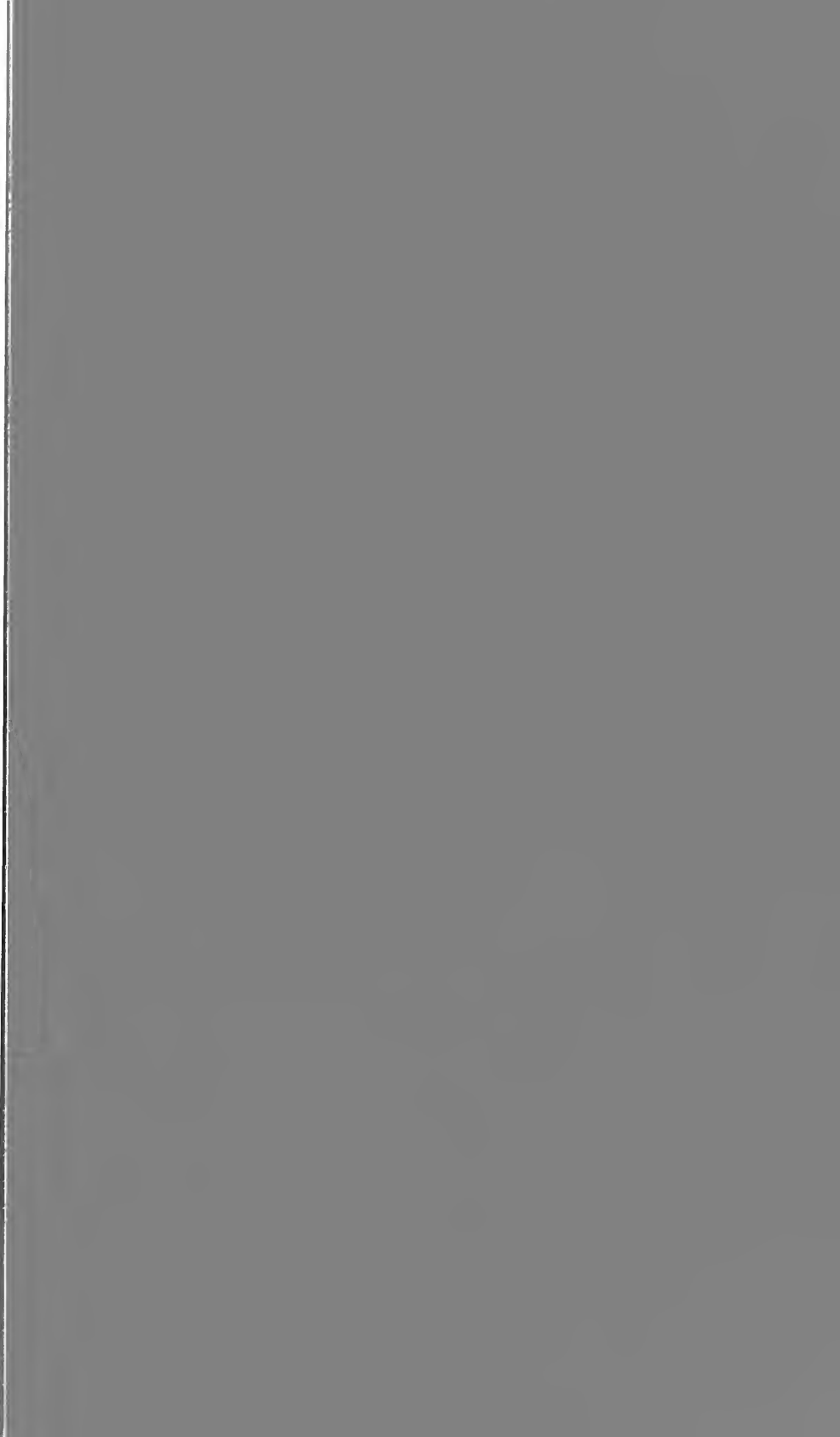
DONALD F. X. FINN

LOWENTHAL & LOWENTHAL

By REED H. BEMENT

By MORRIS LOWENTHAL

Attorneys for Bertha Hecht





Appendix A

*National Association of Securities Dealers, Inc.
District Business Conduct Committee of District No. 2*

Complaint No. A-298

Date Aug. 29, 1968

In the Matter of

Bertha Hecht
338 Virginia Avenue
San Mateo, California

Complainant,

vs.

Harris, Upham & Co. and
Harris, Upham & Co., Inc., Member Firm
540 California Street
San Francisco, California

and

Arthur R. Mejia, former San Francisco
resident partner and now Vice President
of Harris, Upham & Co., Inc.

and

Asa V. Wilder, Registered Representative
for Harris, Upham & Co.

Respondents.

DECISION

Appearances

For the Association

Subcommittee Members

Gerald J. Ehler, Shuman, Agnew & Co., San Francisco, California, Chairman

B. P. Lester, Jr., Lester, Ryons & Co., Los Angeles, California

Harvey J. Franklin, Merrill Lynch, Pierce, Fenner & Smith, Inc.,
San Francisco, California

Robert P. Mann, Davis, Skaggs & Co., San Francisco, California
William C. Richardson, Birr, Wilson & Co., Inc., San Francisco,
California

Joseph Edelstein, Edelstein, Campbell & Co., San Francisco, California

Staff

Frank Wilson, Associate General Counsel, Washington, D.C.

William J. Radding, Jr., Secretary, District No. 2 North, San
Francisco, California

John T. Christensen, Examiner, District No. 2 North, San Francisco,
California

For the Complainant

Donald F. X. Finn, Counsel, New York, New York

Morris Lowenthal, Counsel, San Francisco, California

Reed H. Bement, Counsel, San Francisco, California

For the Respondents Other Than Asa V. Wilder

Emanuel Becker, Counsel, New York, New York

Henry Upham Harris, Chairman of the Board, Harris, Upham
& Co., New York, New York

James F. Burns, Jr., Senior Vice President, Harris, Upham & Co.,
New York, New York

Arthur R. Mejia, First Vice President, Harris, Upham & Co.,
San Francisco, California

BACKGROUND INFORMATION

This complaint was filed on February 21, 1966 by Mrs. Bertha Hecht of San Mateo, California, a member of the public, against Harris, Upham & Co. and Harris, Upham & Co., Inc. in San Francisco; Arthur R. Mejia, its resident manager and Vice President and Asa V. Wilder, registered representative of the member.

Respondents were charged with violations of Article III, Sections 1, 2, 4, 15(a and b), 18, 19(a and e), and 27(a, c and d).

Respondents filed identical answers on September 20, 1966 after requested waivers of time were granted by the Committee. Inas-

much as Mr. Wilder failed to sign the answer form as required by the Code of Procedure for Handling Trade Practice Complaints (the appropriate space contained a typewritten signature), the District Secretary communicated with the respondent member's former counsel, John B. Bates, who advised the Committee by letter that arrangements for Mr. Wilder to sign the original would be made upon Mr. Wilder's return from vacation. Such signature was never received. Mr. Bates further noted that Mr. Wilder's answer had been reviewed with Mr. Wilder and his attorney, Earl C. Mahoney. Mr. Wilder requested a hearing, but refused to appear after appropriate notice was directed to him (see NASD Exhibit No. 7).

A hearing, conducted by a sub-committee of the District Business Conduct Committee was held on March 13, 14, 15, 16 and 18, 1968 in San Francisco, California. Respondent member was represented by Henry Upham Harris, Chairman of the Board, James F. Burns, Jr., senior vice president, and Arthur R. Mejia was present both on his own behalf and on behalf of the member. They were all represented by counsel. The complainant did not appear, but she was represented by counsel. Respondent Wilder did not appear.

SUMMARY OF COMPLAINT

In a 16-page statement of particulars with seven attachments, Mrs. Hecht alleged that on or about May 6, 1957 she was made a customer of the respondent member through Mr. Wilder by transfer of her securities and commodities account from Mr. Wilder's former employer. She alleged that from 1956 until 1964 Mr. Wilder would regularly go to her home one or more times a week at the close of business and take from her all of the confirmations, open orders, and monthly statements mailed to her home address by Harris, Upham & Co. and that Mr. Wilder maintained running accounts and summaries of her positions and equities which he prepared and maintained, and that such summaries contained false and misleading statements.

Mrs. Hecht alleged that between 1957 and 1964 she was away from her home fourteen times because of hospitalization or trips to Europe, the Orient or resorts. She alleged that during these absences, Mr. Wilder initiated and executed substantial discretionary transactions in her securities and commodities accounts.

Complainant alleged that there was an excessive amount of trading activity, improper trading in the short account opened by Mr. Wilder, improper discretionary trading by Mr. Wilder over a number of years and, in addition, that a large proportion of the transactions were of dubious value and bore no relationship to Mrs. Hecht's investment interests and objectives which, it is alleged, were to protect her principal and provide her with a regular dividend income. In this regard, Mrs. Hecht alleged that Mr. Wilder solicited and executed purchases for her account of a substantial number of speculative and over-the-counter issues which were non-dividend paying when purchased.

She alleged also that Mr. Wilder effected the unlawful purchase of "non-blue skied" securities for her account, on the basis of a rumor, which he later privately "redeemed" from her for \$9,400 without the knowledge of his employer.

Complainant questioned the supervision exercised over Mr. Wilder by Mr. Mejia, the managing partner, and later vice-president, in charge of Harris, Upham & Co.'s San Francisco office. The complainant alleged that although Mr. Mejia was formerly a member of the Chicago Board of Trade, he had no knowledge of commodity transactions and was not qualified to give advice on commodity transactions, and that he did not, therefore, supervise Mr. Wilder's commodities activities, although Mr. Wilder reported to him and it was his duty to review Mr. Wilder's accounts.

Complainant also alleged that a number of questionable transactions occurred in her account in which the respondent member acted as principal, asserting that such transactions raised questions

as to the propriety of Harris, Upham & Co.'s markup policy on riskless over-the-counter principal transactions. Finally, it was alleged that there was a disclosed failure of the management of Harris, Upham & Co. to institute or enforce a system of internal controls to protect its customers.

Complainant—Bertha Hecht (nee Bertha Pirrie)

The complainant is a resident of San Mateo, California. She is now 78 years of age and a widow.

She was born in Liverpool, England on November 20, 1890 and went to Canada in 1913. Eventually she settled in California in 1923. On January 13, 1953, she married Mr. Herbert Hecht of San Mateo, California by whom she had been employed to care for his child, Nancy, since the death of his first wife in 1939. Mr. Hecht died suddenly of a heart attack on January 12, 1955, leaving a substantial estate which was divided equally between Mrs. Hecht and her step-daughter.

Mrs. Hecht was educated in England. Her education included a one-year course as a student nurse from which she withdrew after failing her first year medical board examination. She then studied in the south of England for two years and, thereafter, returned to her home where she taught school. After the death of her parents and a short stay in Canada and England, she was employed in a department store in Salt Lake City as a saleswoman. About 1922, Mrs. Hecht moved to San Francisco and was employed in a department store as a saleswoman. Subsequently, she became a housekeeper and tutored and cared for children and, from 1939, raised Mr. Hecht's young daughter after her mother passed away. On January 13, 1953, she and Mr. Hecht were married.

Complainant contends that ever since her husband's death, she has suffered from a series of debilitating, physical and mental illnesses which have impaired her ability to function properly and to comprehend her situation.

Respondent—Arthur R. Mejia

Mr. Mejia attended the University of California from 1919 to 1920 and the Ecole Pascal in Paris from 1920 to 1921. In 1923, he entered the employ of William Cavalier & Co. in San Francisco, a firm engaged in general stock brokerage and securities underwriting.

In 1937, Mr. Mejia became a partner in the stock brokerage and commodities firm of Davies & Mejia and in 1951 he became the resident partner of Harris, Upham & Co.'s newly opened San Francisco office. Since the incorporation of Harris, Upham & Co. in 1965, Mr. Mejia has been a director and first vice-president and a stockholder. During the hearing, Mr. Mejia acknowledged that he was the senior supervising executive in charge of Harris, Upham & Co.'s San Francisco branch office since it opened in 1951.

Respondent—Asa V. Wilder

Mr. Wilder was employed by E. F. Hutton & Co. in San Francisco in 1920 and 1921. After serving for a year in the army, he was re-employed by E. F. Hutton in New York City in 1922 and 1923. From 1924 to 1929, Mr. Wilder was a bank teller for the Oakland Bank and studied at the American Bankers Association. From 1929 to June 1954, he was employed at Merrill Lynch, Pierce, Fenner & Beane and its predecessor firms. In 1954, Mr. Wilder became a partner of Hooker & Fay, a former member of the NASD in San Francisco, and established a commodity department for that firm. He resigned as a partner of Hooker & Fay in April 1957 and became associated with Harris, Upham & Co. as a registered representative and manager of the commodity department in Northern California. Mr. Wilder was in charge of supervising the commodity department of Harris, Upham & Co.'s San Francisco, Oakland, Stockton and Sacramento offices.

At the time of his appointment by the respondent member, Mr. Wilder was a member of the Chicago Board of Trade.

*Respondent—Harris, Upham & Co. and
Harris, Upham & Co., Inc.*

Harris, Upham & Co. was founded in 1895 and presently has approximately 64 branch offices in 32 states.

Harris, Upham & Co., originally a partnership, changed to corporate status (Harris, Upham & Co., Inc.) on September 1, 1965. It employs approximately 1,500 employees, including 670 registered representatives. It has about 35 officers.

The firm will be referred to hereinafter as Harris, Upham, regardless of whether the reference is to the period prior to or after incorporation.

After 1951 and under Mr. Mejia's direction and supervision, Harris, Upham expanded its operations to Northern California. It opened offices in Stockton and Oakland in the 1950's and a Sacramento office in 1964.

Since September 1, 1965, the chairman of the board of Harris, Upham has been George Upham Harris. The president and chief executive officer has been Henry Upham Harris, Sr.; the executive vice-president has been Henry Upham Harris, Jr.; the controller has been Matthew Smith; and the vice-president in charge of security regulations has been James F. Burns, Jr. These individuals have performed the same functions since 1957. The commodities department has been under the direction of George Upham Harris, at least from 1957.

Witnesses at the Association's Hearing

Mr. H. V. Petrillo has been associated with the accounting firm of Haskins & Sells for thirty-five years. His duties are primarily to supervise the firm's stock brokerage accounts across the nation. Mr. Petrillo has been a certified public accountant for the past thirty years.

William P. Wentworth has been associated with Bergues, Wentworth & Co. since 1940. He was previously affiliated with

Dean Witter & Co. in an investment management capacity after receiving an A.B. degree from Stanford University in 1933 and a M.B.A. degree from Stanford's Graduate School of Business in 1935. Mr. Wentworth is managing partner of the firm and his principal responsibility is the administration of accounts and the development of broad policies.

The firm of Bergues, Wentworth & Co. has been established in the investment management field in San Francisco since 1937 and specializes in the independent management of security portfolios.

Mr. Joseph E. A. Sauer has been a partner with the accounting firm of Barlow, Davis & Wood since 1957. Prior to that, he was a senior accountant with the firm since 1954. From 1941 to 1947, he was employed by Pan American World Airways, Inc. as a supervisor in the accounting department. Mr. Sauer was associated with several accounting firms as a senior accountant between 1947 and 1954. Mr. Sauer graduated from the University of California, College of Commerce, Berkeley, in 1941 with a B.S. in economics. During 1946 to 1948, he attended graduate school at Golden Gate College and majored in accounting with emphasis on auditing of stock brokerage firms. Mr. Sauer is currently a member of the California Society of Certified Public Accountants and also the American Institute of Certified Public Accountants.

Background of Complaint

Although the complaint was filed in 1966, it was the District Business Conduct Committee's determination that inasmuch as the complaint paralleled a legal action in the United States District Court for the Northern District of California by Mrs. Hecht as the plaintiff, versus the respondents as the defendants, this matter should be postponed pending determination by the court. At the hearing, Mrs. Hecht and Mr. Wilder did not personally appear. Mrs. Hecht, however, was represented by counsel and submitted a letter from her doctor stating that it would be best if she not be

required to appear. Consequently, the Committee accepted for review, and as part of the record, the complete transcript and record of the court proceedings. The entire transcript and record was also admitted in the interest of fairness, in that parts of it had been admitted during the course of the hearing by stipulation of respondents' counsel. From this transcript and the additional material presented at the Association's hearing, the determination herein has been made.

The Relationship between Mrs. Hecht and Mr. Wilder

Mr. Wilder lived near Mrs. Hecht and, immediately following the death of Mr. Hecht, temporarily took Mrs. Hecht into his home when she was emotionally upset. Mr. Wilder took the responsibility for the preparation of detailed schedules for inclusion in Mrs. Hecht's income tax returns, reflecting capital gains and losses arising from securities transactions and commodity futures transactions. He arranged, in 1957, for a San Francisco accounting firm, Barlow, Davis & Wood, to handle Mrs. Hecht's income tax returns. During the hearing, Mr. Sauer stated that his firm reviewed the arithmetical computations set forth in the schedules given to them by Mr. Wilder to determine whether they were correct and that the firm looked to Mr. Wilder as Mrs. Hecht's financial advisor.

Our concern with this relationship is directed to the amount of reliance placed upon Mr. Wilder by Mrs. Hecht for her business affairs. We note from the record that Mr. Wilder prepared numerous checks for Mrs. Hecht's signature for income and property tax payments and for the deposit of funds into Mrs. Hecht's security and commodity accounts. Mr. Wilder, from time to time, prepared statements of account for Mrs. Hecht's review which he showed and explained to Mrs. Hecht in detail. In this regard, Page 18 of the complainant's court trial memorandum of fact had this to say:

"All of the securities, ledger sheets and reports were apparently kept by Mr. Wilder in a black ring binder notebook which he would deliver (after first removing the "condition

of account" report of accomplishments documents) to Mrs. Hecht's accountants at income tax time for several weeks. He would then pick the black book up, which he retained in his possession (Transcript 1788, 1792-1793). The black book, as turned over to Mrs. Hecht's accountants by Mr. Wilder, contained only the ledger sheets on current securities transactions and the schedules of capital gain or loss on security and commodity transactions for that year (Transcript 1763, lines 22-25; 1764, lines 1 to 2). All other materials were removed by Mr. Wilder prior to delivery (Transcript 1772, lines 11-17). At no time, however, did Mr. Wilder provide Mrs. Hecht's accountants with the "condition of account" or report of accomplishment documents he prepared for Mrs. Hecht or inform them of their existence (Transcript 1772-1773). Mr. Wilder specifically admitted that they were not for the accountants, but for himself (Transcript 2119-2120) and for Mrs. Hecht's account at Harris, Upham & Co. (Transcript 2136, lines 4 to 6)."

Securities Account

Exhibits prepared by the staff of the Association indicate that during the period or life of the account with Harris, Upham, from May 16, 1957 through March 31, 1964, there were a total of 563 purchases and 477 liquidations. It should be noted that the staff counted all purchases and sales of the same stock on the same day as one purchase or as one sale. There were, however eight special situations which were counted in the purchases, but not in the liquidations. The security purchases aggregated \$4,799,128.78 and the liquidations aggregated \$4,921,279.46. The turnover rate as determined by the staff, was 11.7. Mrs. Hecht's total contributions to the account, including cash and securities, equaled \$407,617.41. At the end of the period, there was a profit in the securities account of \$37,274.22, while there was an overall loss from commodity transactions of approximately \$176,000. During the period, commissions to the firm on security transactions totaled approximately

\$76,468.00, not considering markups or concessions on principal transactions or an additional amount of \$98,333.00 on commodity transactions. The value of the accounts, including debit balances as of March 31, 1964, was approximately \$251,308.00 (compiled from complainant's Exhibit 12 and 13).

In addition to the securities margin and cash account and the commodity account opened in Mrs. Hecht's name by Mr. Wilder in May 1957, a special short account was opened in 1958 and a so-called commodity "tax maneuver" account was opened in 1959. It is significant to note that the short account resulted in a total loss of \$10,474.91 from sales of IBM, Ampex, and Westinghouse. During the period in question, there were 8,900 commodity future transactions effected for Mrs. Hecht's account.

FACTS, FINDINGS AND CONCLUSIONS

In 1955 and 1956, Mrs. Hecht received substantial cash distributions from her husband's estate which permitted her to deposit in excess of \$118,000 in an account with Hooker & Fay, a firm which is no longer in existence. Prior to the establishment of the account at Hooker & Fay, Mrs. Hecht had maintained an account at Walston & Co. with an approximate worth of \$42,000. This account was opened about 1929 and was handled by a presently registered representative, Ernest Fairey.

The respondents urged the Committee to consider the knowledge and competence of Mrs. Hecht prior to and during the establishment and activity of her account with Harris, Upham and urged the Committee to consider her general market exposure of about 40 years.

Respondents noted that most of Mrs. Hecht's purchases and sales were executed on an agency basis. The exchange and over-the-counter agency commissions over a period of seven years totaled \$76,563.00 of which \$4,391.00 were over-the-counter. Total principal transactions were \$591,000.00 of which approximately one-half

were secondaries. Respondents contend, in effect, that Mrs. Hecht was an experienced and knowledgeable trader. The complainant contends that she was not a trader and speculator before Mr. Wilder took over her account. In fact, it is claimed that there was very limited activity in her account at Walston & Co., as reflected by the fact that from 1939 until 1955 only 41 purchases and 32 liquidations were effected in the account. In addition, a schedule introduced in the hearing revealed a number of years during which no sales were made, and in no year were more than five sales made. Essentially, the complainant claims that far from being a "trading" account, the Walston account was strictly for investment purposes and was an account in which very few transactions were made over a long period of time. In support of her contention that the Walston account was not a trading account, note was made of the lengthy holding period of securities before they were sold. Some securities were sold in May 1953 to raise funds, according to the complainant, for the purchase of a home. But even after substantial sales in this account in 1953 and 1955, the account had a net value of over \$42,000 in 1955 immediately prior to its transfer to Hooker & Fay with Mr. Wilder as the account representative. Complainant has noted that the account was limited to security investments and did not include commodities.

We have reviewed carefully the entire record in this case and we are convinced that Mrs. Hecht, at least during the years 1930 until 1955, had acquired enough knowledge of the securities market to exercise adequate judgment in her dealings with securities dealers. However, it is also apparent that after the death of her husband, there was a progressive deterioration of her mental and physical well-being. We are not convinced, therefore, that Mrs. Hecht was fully capable of exercising proper judgment during the years Mr. Wilder handled her account.

It must be noted that the Committee does not consider this earlier period of securities dealings to be of importance in reach-

ing our decision, because complainant's needs, objectives, and mental and physical condition were then vastly different. We will, however, note the conflicting contentions of the parties. Respondents claim that Mrs. Hecht exhibited knowledge of the securities market by substantially increasing the value of her account during this time. Mrs. Hecht testified that the account was handled and managed for her during this period by Mr. Hecht and Mr. Fairey. If this is true, and Mr. Fairey's testimony indicated that such was possibly the case, the gain in the account up to 1955 was due to its handling by Mr. Hecht and Mr. Fairey, rather than to any astuteness or knowledge on complainant's part.

Most important to judgment in this matter for the period subsequent to 1955 is the extent to which Mr. Wilder was able to control the account and to manipulate transactions to his own advantage, such as the Itek and Colonial situations presented below.

The Colonial Transaction

Mr. Wilder arranged for the purchase of 220 shares of Colonial Savings & Loan Association from a friend. He had Mrs. Hecht transfer to him a check for \$15,000 drawn from her account at Harris, Upham. This amount covered purchase of 120 shares, with a check from Mr. Wilder for \$12,000 being used to cover the purchase of the additional 100 shares.

Pursuant to Mr. Wilder's instructions, Mrs. Hecht received a certificate for only 100 shares instead of the 120 shares for which she had paid, while Mr. Wilder received 120 shares, rather than the 100 shares for which he had paid. At a later date, Mr. Wilder arranged for the purchase by Mrs. Hecht of an additional two shares.

In 1961, Colonial announced a 10 to 1 stock split and the original shares were worth about \$360 per share by September 1961. Just prior to the split, Mr. Wilder obtained from Mrs.

Hecht a transfer to himself of her 102 shares. While Mr. Wilder claims that these shares plus the original twenty were transferred to him as gifts, the complainant denies any knowledge of the transaction and specifically denies that she ever made a gift of securities to Mr. Wilder, as she had provided for Mr. Wilder through her wills. It should be noted that Mr. Wilder treated this "gift" as a sale for purpose of Mrs. Hecht's 1961 income tax and reported it as such to Mrs. Hecht's accountants.

Although the Colonial transaction occurred in January 1961, Mr. Wilder placed it between two entries for April on the 1961 capital gains schedule he prepared for use by Mrs. Hecht's accountants in preparing her income tax return. Complainant has noted that this is the only entry not in chronological order in those summaries prepared by Mr. Wilder for Mrs. Hecht's accountants.

The Itek Transaction

On November 14, 1958, Mr. Wilder, acting on a rumor, purchased for the account of Mrs. Hecht 100 shares of Itek stock at \$94 per share. At the time, Itek had not been "blue skied" in the state of California. After the purchase, Harris, Upham called this matter to Mr. Wilder's attention, indicating that it should be removed from the account of Mrs. Hecht. According to the record, Mr. Wilder called on Mrs. Hecht to explain that the stock was speculative and he told her that he would redeem it from her, all the while aware of the fact that as of January 1959 Itek had declared a 400 percent stock dividend in the form of a 5 to 1 split as a result of which the stock had risen from \$94 per share to \$300 per share. Mr. Wilder brought a check for \$9,400 and prepared a receipt reciting payment in full for 100 old (500 new) shares of Itek Corporation with all accrued rights. In some manner, he managed to secure Mrs. Hecht's endorsement of the new shares over to himself, placed the shares in his wife's account at

Harris, Upham, and later sold the stock for \$25,400 with a resultant profit of \$16,000.

We believe that the above actions by Mr. Wilder, with the unknowing consent of Mrs. Hecht, establish without a shadow of a doubt the absolute control Mr. Wilder exercised over the activities in this account. Furthermore, we have noted that the size and extent of all of the accounts tested the abilities of the experts for the purposes of analysis. How then could Mrs. Hecht possibly have been totally aware of her constantly changing positions, her buying power, and her profit and losses without maintaining and preparing for herself some sort of records related to her portfolio transactions? As already noted, Mr. Wilder prepared capital gains and loss schedules for her tax accountants and statements of account for Mrs. Hecht. He picked up copies of all confirmations and statements weekly, sometimes more often. It is evident from the record that Mrs. Hecht consistently relied upon Mr. Wilder to provide a businesslike and adequate judgment over the transactions to take place in her account. Beyond this, Mrs. Hecht has emphatically contended that certain securities left to her by her husband were never to have been sold. Further, she wanted securities that would provide income, as she had no source of revenue other than her securities account.

Respondents assert that the issue before the Committee is narrowed to the responsibility of a broker to a customer who has known the cost and risk of trading for years and has all the information needed to make her own decisions. We do not deny that Mrs. Hecht received most of the information needed to make her own decisions, had she been capable of doing so. The facts are, however, that Mrs. Hecht was not capable and did not make her own decisions, that she relied upon Mr. Wilder, and that her objectives were directed by Mr. Wilder.

To cement our position, we need only look further at the history of Mr. Wilder's activities related to this account. The account

was transferred to Harris, Upham in May 1957, at a time when Mrs. Hecht was not in the country. Mr. Wilder claimed that Mrs. Hecht left on a five-week cruise to the Orient only after he returned to San Francisco from a meeting of Harris, Upham principals in New York about April 1, 1957 and he had her sign a blank transfer form. Subsequently, upon her return from her cruise to the Orient around May 7, 1957, Mrs. Hecht signed a new account information card which covered the opening of a securities margin account and a commodity futures account. Mr. Wilder testified in court that during Mrs. Hecht's March 28-May 7, 1957 cruise to the Orient, he had discretion to "take care of her accounts while she was away." During this absence, on May 3, 1957, Mr. Wilder effected the sale of contracts of May soya bean oil worth \$42,930 at Hooker & Fay. According to complainant, there was a total loss in this transaction of \$5,162. Of importance here, however, is the fact that Mr. Wilder had already been employed by Harris, Upham on May 1, 1957. In the Harris, Upham account on May 3, 1957 and prior to Mrs. Hecht's return from the Orient, Mr. Wilder bought six contracts of January soya bean oil for Mrs. Hecht. Mr. Wilder has admitted (Court Transcripts 1179-1184, 1142, 1129) the use of discretion in effecting numerous commodity transactions on occasion when Mrs. Hecht was in the hospital or away from her home and, as already noted, he kept all of her account records in his possession. Mr. Wilder admitted that he solicited and initiated every commodity transaction effected for Mrs. Hecht, claiming that it was very "seldom" that she refused to follow his recommendations and advice on commodities, but was unable to recall any specific instance when this had ever, in fact, occurred (Court Transcript 1437-1438). More important, Mr. Wilder has admitted that of some 200 different securities purchased and sold in Mrs. Hecht's account, the only transactions he did not solicit and recommend were 100 shares of Ampex and 200 shares of Creamery Package. Obviously,

every transaction, excluding those two in Mrs. Hecht's account at Harris, Upham, resulted from Mr. Wilder's initiative.

It should be noted that Mr. Wilder repeatedly requested information from the main office in New York as to the buying power in Mrs. Hecht's account. Additionally, in July 1960, immediately after the margin requirements had been dropped from 90 to 70 percent, Mr. Wilder transferred \$100,000 from complainant's margin to cash account. These actions are indicative of Mr. Wilder's desire to utilize to the fullest extent possible the buying power in Mrs. Hecht's account.

With regard to the subject of confidence and control, respondents Harris, Upham and Mejia urged the Committee to consider the following:

"NASD Rule No. 15 applies to customer's accounts in respect to which a broker is vested with any discretionary power. Harris, Upham & Co. does not permit discretionary accounts. Mr. Mejia testified that he reminded his registered representatives regularly of the prohibition. At one time, in accordance with the New York office's request he required them, including Mr. Wilder, to sign a statement that they did not have discretionary authority over any account.

It is generally agreed that unless a customer has confidence in a broker so that the account is effectively discretionary, there can be no churning. The Committee will have noted that Judge Sweigert did not find that Mrs. Hecht had confidence in Mr. Wilder. Mrs. Hecht testified again and again that she had no confidence in him and she did not feel "secure" since 1957 (see our factual summary page 14, paragraphs 21 to 23). But it is suggested that Mr. Wilder had control over the account. Control in the absence of confidence is not in our opinion a meaningful description of a broker/customer relationship, especially when a customer talks to a broker every morning at 8:00 a.m. and questions transactions every day or every week. Whether or not Mrs. Hecht made the decisions to purchase or sell (we believe she did and Mr. Fairey confirms this), she had daily knowledge of

what was being purchased and sold; she was privileged to say "no". Lacking confidence in Mr. Wilder, she no doubt did. Most of the decisions were hers; she controlled. Her doctors assured us she does not take advice; she listens, but does what she pleases."

We disagree with the respondents' dissertation and the obvious answer could take the form of a query: "Did Mrs. Hecht understand the consequences when Mr. Wilder approached her concerning the Itek and Colonial transactions?". Furthermore, discretion is not always reduced to writing. Respondents are well aware of the fact that discretionary relationships do develop between client and representative.

Respondents assert that this Committee has no jurisdiction over the commodities transactions in complainant's account at Harris, Upham. While agreeing that this Committee has no jurisdiction over commodities transactions as such, the Committee does not agree that this means such transactions are to be totally ignored in considering this matter. Respondents had a duty to treat this portfolio as an investment account; and in considering whether they adhered to their duty, the Committee cannot ignore what was done with a substantial portion of the proceeds of that portfolio. The commodities and securities accounts were inter-related and funds were freely transferred between the accounts. In viewing the overall investment picture of complainant, it is impossible to ignore the commodities transactions as a whole. It would make no more sense to ignore the commodities transactions than it would to say that this Committee could not consider a conversion by a representative of proceeds from a sale of securities.

Insofar as excessive trading is concerned, respondents contend that the account in and of itself is a trading account and not an investment account and that the SEC has never criticized a trading account as excessive. In this regard, respondents had this to offer:

"The SEC has never criticised a trading account as excessive. It has never criticised an investment account with a rate of turnover comparable to complainant's. A portfolio turnover of 7.11 (weighted average) for 7 years in a trading account, or approximately once a year, is in our opinion hardly excessive. If the account had been an investment account, then perhaps capital invested as distinguished from total portfolio, would be an appropriate base for computing turnover. But we suggest that in a trading account the portfolio should be the base if an accurate picture of the account's activity is to be obtained.

Complainant did not have 9000 commodity transactions although she may have, if her count is accurate, bought and sold 4500 contracts. A count of contracts bought and sold is comparable to a count of the number of shares purchased and sold. More realistically, complainant took approximately 700 positions in 7 years. "Turnover" of capital in commodities cannot be appraised by security account standards; the capital in the account is generally the margin required by the particular commodity exchanges. The purchase and sale of one contract per month over a period of 7 years will produce substantially the same rate of "capital turnover" as in complainant's account. Mr. Steers, who testified at the trial, stated a monthly turnover would not be churning, and a careful conservative trader will always cut his losses quickly. We will be pleased to furnish the transcript of Mr. Steer's testimony. There is no evidence of churning of commodities in the record of this case.

Of particular significance to the Committee is the fact that the complainant does not charge excessive trading of commodities, her failure to understand commodity trading, or any other breach of fair and equitable practice with respect to commodities, only that Mr. Wilder engaged in straddles for her without her understanding. Assuming straddles were without complainant's understanding, did the straddle help her or hurt her? The testimony of Mr. Wood, her accountant, is that the losses sustained in December 1958, apparently the first leg of the straddle, were used to offset profits for tax purposes in that year."

We have already noted that Mrs. Hecht was in need of income and that her basic objectives were investment and not trading. Respondents' argument fails to consider that her needs and objectives, as an elderly widow, were of an investment nature; that is, stability of capital and receipt of dividend income. In view of the reliance by Mrs. Hecht upon Mr. Wilder for the handling of her securities account and his total control of that account, the respondents had a duty to treat her account as an investment account. Respondent refers to a weighted average of turnover. We see no need for engaging in an argument of turnover figures. There is, in this account, an apparent pattern of in and out trading and a relatively short period of time that securities were held in the account before being sold. Considering the securities account only, we can present a monthly picture of activity, as reflected on the attached schedule.

In view of the above, we find that each and every transaction effected in Mrs. Hecht's securities account was excessive in size and frequency, in relation to the character and resources of her account. We further find that each and every transaction constitutes a separate and distinct violation of Sections 1 and 2 of Article III of the Rules of Fair Practice by the respondent Asa V. Wilder and that such activities by Mr. Wilder constitute violations and acts contrary to provisions of Sections 15, 18, and 19 of Article III of the Rules of Fair Practice. We further find that such violations by Mr. Wilder represent conduct inconsistent with just and equitable principles of trade.

As the funds utilized in the commodities transactions were in a large part transferred from Mrs. Hecht's securities accounts, we find that the transfer of funds from the securities account to the commodities account was improper; and we believe we can rightly find that each of those transactions individually, or all of them in the aggregate, constitutes a misuse and unsuitable use of her funds for the purpose of "churning" her account, all of which

was fraudulent in nature, in violation of Article III, Sections 2 and 18 of the Association's Rules of Fair Practice, taking into consideration the financial situation and needs of Mrs. Hecht.

The Committee also concluded and we so find that as a whole the account was improperly managed by the respondent and that each and every transaction, considered in relation to all other transactions and in relation to the account overall, was unsuitable. Although it may be claimed that specific individual transactions when viewed in isolation are not inappropriate for an investment account, when such transactions are placed in the context of an excessively traded account which declines both in value and in income, it is clear that such individual transactions must also be considered unsuitable.

It should be noted that our finding of "unsuitability" does not go only to the aggregate account; that is, the combined securities and commodity accounts, but to the individual transactions in the securities account and to the overall handling of the accounts. The act of putting an elderly widow of failing faculties into non-income producing and speculative holdings is itself an act of "unsuitability" of such magnitude to require revocation.

An important factor considered by the Committee in reaching its decision that the complainant's account had been handled in an unsuitable manner was the speculative and non-dividend paying nature of securities purchased. Mr. William P. Wentworth, an experienced investment advisor and a partner of the investment advisory firm of Bergues, Wentworth & Co. of San Francisco, gave a detailed analysis of the condition of Mrs. Hecht's account as of March 31, 1964. Based upon his investigation, he testified that the account showed:

"A history of very active trading in commodities and common stocks to a degree which, in my opinion, was totally incompatible with the stated circumstances of this lady (Transcript 1897). I learned that she was in her middle seventies, that she was a widow and that she was totally

dependent upon this fund for her income. As a result of conversing with her, I gained the judgment that she was totally incapable of managing her affairs from a financial standpoint (Transcript 1898).

Mr. Wentworth further testified that the data he reviewed reflected a history of substantial margin indebtedness against this account to the point where Mrs. Hecht had been placed in a position where the interest on her debit balance absorbed about 90 percent of her income at a time when she was dependent upon this fund solely for her income. Mr. Wentworth noted that her projected gross annual income as of March 31, 1964 was \$11,140 (Court Transcript 1900). The prevailing interest rate of 5 percent would on a debit of \$206,000 absorb nearly 90 percent of her income, leaving her with a net annual income of \$1,000. Permitting an account to be maintained in a condition such as this—where income is a must—is also, in and of itself, an act which violates a broker's obligation to his customer to do that which is proper and in our opinion would alone warrant revocation.

Mr. Wentworth also noted that he made an analysis of the relationship of the speculative stocks to other kinds of stocks in the account as of March 31, 1964. He compared the securities left in the account to the quality ratings by Standard and Poors and Moody's Investment Services (Court Transcript 1900-1901). In this regard, Mr. Wentworth's testimony is quoted below:

" . . . we come up with a total market value of securities in the account in March of 1964 which were rated by these two services in the speculative area—there might have been slight differentials between the two—of \$181,000 market value and \$266,000 at book cost.

"These securities produced an income of \$2,756 per annum, a yield of a mere one and a half percent on market and one percent of the book cost.

"These securities produced an income of \$2,756 per annum, a yield of a mere one and a half percent on market and one percent of the book cost.

"The \$181,000 of speculatively rated securities represented 76 percent of the net account equity which then was \$238,000. In other words, by my judgment the future of Mrs. Hecht's account, Mrs. Hecht's remaining equity, shall we say, depended rather heavily on what happened to the speculative securities. Of the speculative securities totalling \$181,000, 70 percent paid no dividend. And within this group of securities were two blocks of stock, Great Western Finance and San Diego Imperial, which alone totalled \$106,000, which Moody's Investor Service on March 13, 1961 in a one-page analysis of this industry stated, and I quote: 'The stocks of the savings and loan holding companies have become extravagantly valued in relation to reasonable expectation of future after tax earnings. They should be held only by investors willing to live with the speculative risks now involved in them.' From Moody's. (Court Transcript 1902-1903, Plaintiff's Exhibit 262)

" . . . (The) data also revealed commission payments to the broker arising from the trading activity in the account which, in my judgment, were completely disproportionate to the size of the account and financial capacity of Mrs. Hecht. Actually, in my judgment, Mrs. Hecht should not have been on margin at all.

"Q. Did you come to any other conclusion at that time, sir?

"A. Yes, sir. Also was revealed a record of substantial realized and unrealized losses relative to the size of the account.

"Finally, there was a picture which presented a very substantial erosion in liquidating value of the assets during a seven-year period in which common stocks generally, speaking of the averages, showed one of the greatest advances in our history with only two interruptions in 1960 and 1962.

"The figures on declining values from 1957 to 1964, to a net decline in the area of 50 percent (Court Transcript 1905-1906)."

In contrast to the net dividend income of \$1,000 annually found by Mr. Wentworth, there was a net dividend income in 1958, the first full calendar year the account was at Harris, Upham, of over \$17,500. Complainant presented an exhibit, prepared by Mr. Sauer, showing that had the original portfolio of May 1, 1957 been maintained, the net dividend income received on that portfolio would have been over \$108,000 more than the net dividend income actually received. It should be noted that in this computation, the interest charged in June 1957 on the margin debit was used as a standard for each and every month involved. (See Complainant's Exhibit #17)

SUPERVISION

Complainant charged that Harris, Upham and Mr. Mejia were responsible for Mr. Wilder's actions as his employer and that they violated Section 27 of the Rules of Fair Practice by failing to institute and maintain a proper and adequate system of supervision and control.

Respondent Mejia was the partner in charge of the San Francisco office for the entire period in question. As such, he was charged with the primary duty of supervision. Further, Mr. Mejia and his two assistants divided among them the task of reviewing the securities accounts of the individual registered representatives whose accounts Mr. Mejia had the responsibility to review.

In discharging his supervisory duties, Mr. Mejia had available to him the following five aids:

1. The IBM commission runs showing the commissions earned monthly from each registered representative by customer;
2. The monthly account statement for complainant's securities account;
3. The initial account documents signed by complainant, which stated she was a widow, that she was retired, and that she desired to receive her dividends each month;

4. Mr. Wilder's running account of complainant's account, which listed all transactions in the account;

5. An order department tabulation indicating all of the transactions for each client and each representative by name.

Mr. Mejia, in fact, did little to supervise the handling of Mrs. Hecht's account by Mr. Wilder. To approve the opening of her account, Mr. Mejia did no more than to read over the new account card filled out by Mr. Wilder (Court Transcript 248). He did nothing thereafter to determine her needs and objectives, which he admitted he did not know, while assuming it was a trading account. At no time did he talk with her, meet her, or invite her into the office. Nor was her account every reviewed by Harris, Upham's research department, although the Hecht account was admittedly a "substantial" one.

In view of his lack of familiarity with Mrs. Hecht and her needs and objectives, it is clear that any review by Mr. Mejia of complainant's account would be of little value. All Mr. Mejia did, in fact, was to look at complainant's monthly statement once a month, along with 800 or 900 other monthly statements. This review of all the monthly statements consumed only a few hours a month of Mr. Mejia's time and was very general in nature. Mr. Mejia testified that he looked for low priced or Canadian securities, but that he did not seek to determine whether the transactions were suitable for the particular customer.

As to the commodity transactions, there was no review of Mr. Wilder's activities. Neither Mr. Mejia nor anyone else in San Francisco ever reviewed the monthly commodity statements, although Mr. Mejia had the responsibility, according to the firm's senior personnel, of supervising commodity accounts in San Francisco. The New York office "assumed" that Mr. Mejia was supervising Mr. Wilder's commodities activities.

It is apparent that such supervision was inadequate. Adequate supervision would have, at the least, raised questions in the minds of the supervisory personnel of the propriety of such a high degree

of activity and commodity transactions in the account of a "retired" widow. That at no time any such questions were raised or pursued indicates a supervisory failure by Mr. Mejia and the member firm.

The single document which would most likely lead a supervisor to question the registered representative about complainant and her account was the IBM commission runs. The monthly commission runs show the commissions charged to an account for both commodity and security transactions and the commission earned. These runs revealed the substantial commissions charged to complainant, in relation to the total commissions earned by the branch office and by Mr. Wilder.

The commissions charged complainant on securities transactions represented 36.8 percent of the total securities commissions earned by Mr. Wilder for Harris, Upham. This figure varied annually between a low of 28.9 percent and a high of over 54 percent (See Exhibit B of Complainant's Exhibit #1).

The commissions charged complainant on commodity transactions represented 59 percent of the total commodity commissions earned for Harris, Upham by Mr. Wilder over the life of the account and 71 percent for the years 1962 through 1964.

For the life of the account, the commodity commissions charged complainant represented 31 percent of *all* income received on commodities by the San Francisco office of Harris, Upham (See Exhibit A of Complainant's Exhibit #1). For the years 1962 through 1964, the figure was 38 percent and for a least this period, complainant's commodity account was the largest producer of commodity commissions in the San Francisco office.

The combined commissions charged complainant on securities and commodities transactions represented 51 percent of Mr. Wilder's total commissions and 4.7 percent of the total income of the San Francisco office, although representing less than 1/10th of 1 percent of the number of accounts in that office.

Although the IBM commission runs should have caused Mr. Mejia and Harris, Upham to determine the nature of Mrs. Hecht's needs and objectives, it would appear that they responded instead by giving Mr. Wilder a salary increase and two \$5,000 bonuses at the very time (1961) complainant's account was producing the most in commissions. Further, shortly after complainant's account was withdrawn in 1964, Mr. Wilder's salary was reduced from \$1,250 a month to \$850 a month (Complainant's Exhibit #60).

We are concerned that there was no regular review of accounts by principals to provide supervision with respect to the suitability of recommendations. An effective review of Mrs. Hecht's account, which originally consisted overwhelmingly of income-producing, long-term investment stocks and which thereafter became laden with speculative, non-dividend paying securities, should have raised questions of suitability. That no such questions were raised is evidence of a lack of supervision.

Mr. Wilder recommended and effected short sales of three different securities in Mrs. Hecht's account, on which there was a loss of \$10,474. We believe that short transactions are of a speculative nature which would be suitable only for a trading account. Apparently, Harris, Upham agrees to the extent that they require the head of the firm's margin department to report to a partner any short sales for the account of a woman.

That these short transactions did not lead the firm to investigate the nature of Mrs. Hecht's account again illustrates the inadequacies of the member's supervisory practices.

Messrs. Burns and Harris reviewed the member's supervisory practices. They pictured their supervisory operations as a system of decentralized supervisory responsibilities augmented by IBM computer tallies of customer, representative, and branch office commissions and securities totals, including but not limited to a breakdown by securities and customers. These computer "runs" were apparently reviewed in the main office by various officers.

As stated by Mr. Burns, the computer tallies were not sufficient to alert principals as to a supervisory deficiency in the San Francisco branch office.

Apparently, to compensate for these deficiencies, a traveling auditor was employed to visit and review the activities of the branch offices. Mr. Harris noted that prior to 1962, no records were maintained which would reflect the steps taken by this auditor to enforce his "oversight" or "watchdog" activities. Mr. Wilder testified in court that his activities were never directly questioned by the auditor. Too, Mr. Mejia seemed to be unaware or unclear as to just what the auditor was doing.

Harris, Upham presented a guide (Respondents' Exhibit #11) used by the traveling auditor in reviewing branch offices. Although the guide was not prepared until October 1965, the procedures reportedly were used since traveling auditors commenced investigating the branch offices in 1962, and even before.

The only items in this guide which could be said to relate to the supervision of customer accounts are B7, which calls for the personal review of the customer account books maintained by the registered representative, and C3, which calls for discussion of the point that approval is required from the New York office to open a commodity account for a woman. As already noted, Mr. Wilder testified that the auditor never checked his customer account books; and there is nothing in the record reflecting that specific approval was obtained from the member's main office for the opening of a commodity account for Mrs. Hecht.

The use of a traveling auditor was, therefore, of no value to the member in meeting its duty to supervise Mr. Wilder and his handling of Mrs. Hecht's account.

Another indication of the failure of Harris. Upham to supervise adequately its customers' accounts is the allowance of the opening of a commodity account for Mrs. Hecht without meeting the company's own standards. In this regard, Harris, Upham's com-

modity manual (Complainant's Exhibit #44) states that no commodity account may be opened for a woman unless they have sufficient experience and knowledge of commodity trading and then only upon approval of a partner; and also that no commodity account may be opened for any person where the registered representative's judgment dictates the undesirability of its acceptance. This would include an individual adjudged incompetent or insane or otherwise legally incapable of acting in his own behalf. These policies were admittedly in effect (Hearing Transcript page 374) when a commodity account was opened for Mrs. Hecht in May 1957. Yet nothing was done by Mr. Mejia or Harris, Upham to determine that Mrs. Hecht in fact did possess sufficient experience and knowledge in this area, which it is apparent she did not.

The member firm may not exclusively rely upon what a new employee or any employee tells them to discharge their duty to supervise. Although it is not clear even that Mr. Wilder was questioned regarding Mrs. Hecht's competence or ability regarding commodities or securities, the firm was obliged to take further steps to satisfy itself that Mrs. Hecht was fully aware of the risks involved in an active commodity trading account. This was not done.

Harris, Upham, in stressing to this Committee that its policy is one of decentralization and delegation of authority, insists that such decentralization and delegation is a necessity in a large national organization such as theirs. Although the Committee is well aware that authority must be decentralized and delegated in large operations, it is also apparent that responsibility ultimately rests with the member. Such responsibility cannot be avoided on the basis of the delegation of authority; and a firm, which can only act through individuals, must bear the responsibility for those who act in its name. Any other approach would permit a member firm to disclaim responsibility by merely "delegating" all authority in the area of supervision of customers' accounts to its registered

representatives—the very individuals whom the member must supervise.

In this regard, it is also appropriate to note that Harris, Upham was censured by this Committee in July 1958 for a lack of supervision in its San Francisco office. The Committee's action was affirmed by the Board of Governors. This discipline was imposed after the filing of a complaint on April 10, 1957, charging Harris, Upham, one of its registered representatives, and another firm with violations arising from the parking and interpositioning of securities owned by Harris, Upham.

The position of Harris, Upham was that it was not an active participant in the transactions handled by its registered representative. The decision of this Committee responded as follows:

"A member firm of the Association cannot, of course, be expected to discover immediately every violation of the Rules of Fair Practice which is committed by its employees. In this case, however, the transactions were carried on over a period of time, and we are forced to the conclusion that a number of the transactions could have been prevented if proper standards of supervision had been followed by Harris, Upham."

Thus, Harris, Upham was especially placed upon notice by this Committee of the inadequacy of its supervision of its registered representatives in San Francisco at the very time Mr. Wilder first became employed and at the very time Mrs. Hecht first became a customer of Harris, Upham. This special notice of inadequate supervision further highlights Harris, Upham's failure to supervise Mr. Wilder, a new employee, adequately and his handling of Mrs. Hecht's account.

It is apparent that there were no supervisory practices in the home office in New York which would discover supervisory deficiencies in San Francisco. The prime supervisory responsibility, according to Mr. Henry U. Harris, Sr. (Hearing Transcript page

590), was vested in Mr. Mejia. The sole responsibility to check for suitability or for a "blue sky" violation rested with Mr. Mejia.

There is no review in New York of the monthly statements for customers of the San Francisco office, nor is there any check made to see whether the partner in charge of an office has knowledge of each customer's investment needs and objectives.

The review in New York was limited to a daily check on the total quantities of each stock purchased that day by all of the Harris, Upham offices.

As to commodities, the review in New York was limited to a weekly review of the overall position of Harris, Upham's customer's in each commodity. This review is not broken down by individual customer and has nothing to do with the commitment or suitability of an individual customer's commodities position. According to Mr. Henry U. Harris, the job of supervising the commodities business in the San Francisco office was delegated to Mr. Wilder.

Although Harris, Upham has introduced various memoranda setting forth its supervisory procedures, it is clear in the context of the case that its practices were inadequate. This Committee is not called upon to say what practices and procedures would here have been adequate. It is sufficient to note, as we do, that had adequate procedures and practices been in effect, the improper handling of Mrs. Hecht's account by Mr. Wilder would have been detected and would not have been permitted to continue for almost seven years. As this Committee noted in its earlier censure of Harris, Upham for failure to supervise, although a member firm cannot be expected to discover immediately every violation of the Rules of Fair Practice committed by its employees, it is required to detect and act when there is a series of improper transactions carried on over a period of time. In this respect, Harris, Upham has failed in its duty.

We find, therefore, that Harris, Upham failed to exercise proper and adequate supervision of its branch office manager,

Arthur Mejia, and its registered representative, Asa V. Wilder, for each and every transaction in Mrs. Hecht's securities account and that such failure constitutes a separate and distinct violation for each and every transaction of Sections 1 and 27 of Article III of the Rules of Fair Practice and that such violations on the part of Harris, Upham represent conduct inconsistent with just and equitable principles of trade.

We further find that Arthur Mejia failed to exercise proper and adequate supervision over Asa V. Wilder, for each and every transaction in Mrs. Hecht's securities account and that such failure constitutes a separate and distinct violation for each and every transaction of Section 1 and 27 of Article III of the Rules of Fair Practice and that such violations on the part of Arthur Mejia represent conduct inconsistent with just and equitable principles of trade.

Mark-Ups

Complainant has raised questions and made allegations related to Harris, Upham's mark-up policies, specifically alleging that the respondent member violated Section 4 of Article III of the Rules of Fair Practice. During the life of the account, there were 64 principal transactions. It was not possible to determine the actual mark-ups (respondents' comparisons from off-setting transactions were either lost or they were unable to locate them), and respondents have stated that the mark-up on principal transactions is generally equivalent to stock exchange commissions; a larger mark-up requires a partner's approval; and under Harris, Upham's policy is never more than 3 percent of the principal amount.

We have reviewed carefully all of the material introduced at the hearing related to this subject, and we can find no evidence to indicate a pattern of high mark-ups levied in principal transactions consummated for Mrs. Hecht; nor is there any reason to believe that the respondents acted contrary to the provisions of the Board's

5 Percent Policy. Accordingly, we hereby dismiss the complaint as it relates to this allegation.

PENALTIES

On the basis of our findings and the above considerations, it is the decision of the Committee that the following penalties be levied against the respondents:

1. That Asa V. Wilder's registration with the Association be revoked and he be fined \$10,000.

2. That Arthur R. Mejia's registration with the Association be suspended for a period of five days and that he be fined \$5,000, such suspension to commence at a date to be set by the President of the Association.

3. That the respondent member, Harris, Upham & Co., Inc. be censured and fined \$50,000.

4. That the respondents, Harris, Upham & Co., Inc., Arthur R. Mejia, and Asa Wilder be jointly and severally assessed the cost of the proceedings as follows:

| | |
|----------------------------|-------------------|
| Hearing Transcript | \$2,897.50 |
| Duplications | 3,021.44 |
| Printing of Decision | 249.74 |
| TOTAL | <u>\$6,168.68</u> |

DISTRICT BUSINESS CONDUCT COMMITTEE No. 2

by /s/ G. J. EHLER
Chairman

Appendix B

*United States District Court
Northern District of California*

No. 44137 (Civil)

Filed Sept. 25, 1968.

Bertha Hecht,

Plaintiff,

vs.

Harris, Upham & Co., a partnership, Harris,
Upham & Co., Inc., a corporation, Arthur
R. Mejia, Asa V. Wilder, George Upham
Harris, Henry Upham Harris, Jr., Frank L.
Patty, et al,

Defendants.

MEMORANDUM OF DECISION
RE MOTION TO REOPEN CASE

On March 29, 1968 the court rendered its final judgment in favor of plaintiff for \$504,391.02 and the judgment has been on appeal by both parties since April 1968.

On August 30, 1968 plaintiff moved for an order indicating the willingness of the court to reopen the case (as allowed by Rule 60[b] Fed. R. Civ. P.) on the issue of punitive damages and upon the ground of (1) alleged fraud of defendant Harris Upham, and (2) newly discovered evidence.

At the hearing of this motion on September 20th last plaintiff established that defendant Harris Upham, when presented in January 1966 with pre-trial interrogatories asking whether Harris Upham had ever been censured or otherwise disciplined by the National Association of Security Dealers, answered to the effect

that, between May 1957 and March 1964, the firm had not been so censured.

Plaintiff also established that this answer was just not true because, as now conceded in open court by counsel for Harris Upham, the firm had in fact been censured by NASD in July 1958 for lack of supervision in its San Francisco office.

Whether this answer was given inadvertently or through misunderstanding or, as alleged by plaintiff, fraudulently, the answer did certainly deprive plaintiff of discovery information to which she was entitled for trial purposes but which she did not become aware of until as recently as August 1968, four months after the judgment when the censure was disclosed in a decision handed down by the District Business Conduct Committee of NASD disciplining Harris Upham for its failure to supervise the Hecht account.¹

The court holds, however, that the deprivation of plaintiff's right to introduce into the trial evidence of the NASD censure of July 1958, was, fortunately, not prejudicial and, therefore, would not warrant setting aside the March 1968 final judgment of this court in order to re-try the issues of either lack of supervision or exemplary damages.

The newly discovered evidence, even if placed in the record, would be competent only for the limited purpose of showing the *fact* of the July 1958 NASD censure—not for the purpose of proving the propriety of the censure in the absence of some admission by Harris Upham.

Further, proof of this previous censure could possibly relate

1. Although plaintiff subpoenaed NASD records to the trial, the records were not delivered to plaintiff because, upon a claim of confidentiality by NASD, the records (twelve large envelopes filled with documents) were examined in camera by the court and reported on by the court as shown in Transcript p. 4406-4410. Plaintiff's counsel, lacking the discovery information requested in their interrogatories, were in no position to assist the court by directing attention to the existence or evidentiary significance of documents which might have disclosed the censure.

only to two issues: (a) the issue of lack of supervision of the plaintiff's account by Harris Upham, e.g., showing similar lack of supervision of other accounts in the San Francisco office, and (b) to the issue of exemplary damages, e.g., showing that Harris Upham had been reminded and warned by NASD through the July 1958 censure of its supervisory inadequacies as a factor bearing upon its wilfulness in failing to supervise plaintiff's account.

As to (a), the showing of other similar instances of lack of supervision as bearing on the issue of lack of supervision, the newly discovered evidence would be merely cumulative since this court has already found in favor of plaintiff that Harris Upham did in fact fail to provide adequate supervision of the handling of plaintiff's account.

As to (b), the showing of previous reminder and warning as bearing on the issue of wilfulness and exemplary damages, the evidence would be also cumulative because the trial record clearly shows that there never was any genuine dispute but that Harris Upham at all times well knew and understood its supervisory obligations without need of any reminder or warning from NASD. Thus, the evidence could add nothing to the element of wilfulness of the firm's failure to supervise.²

Further, exemplary damages are never a matter of right, always a matter in the discretion of the fact finder—even though it be established in point of fact that elements exist which would warrant exemplary damages. 25 *C.J.S. Damages*, § 117(2), p. 1116; *Lane v. Gorman*, 347 F.2d 332 (10th Cir. 1965); *Stoody v. Roher*, 374 F.2d 672 (10th Cir. 1967); *Triton v. Committee*, 43 Cal. Rptr. 504 (1965).

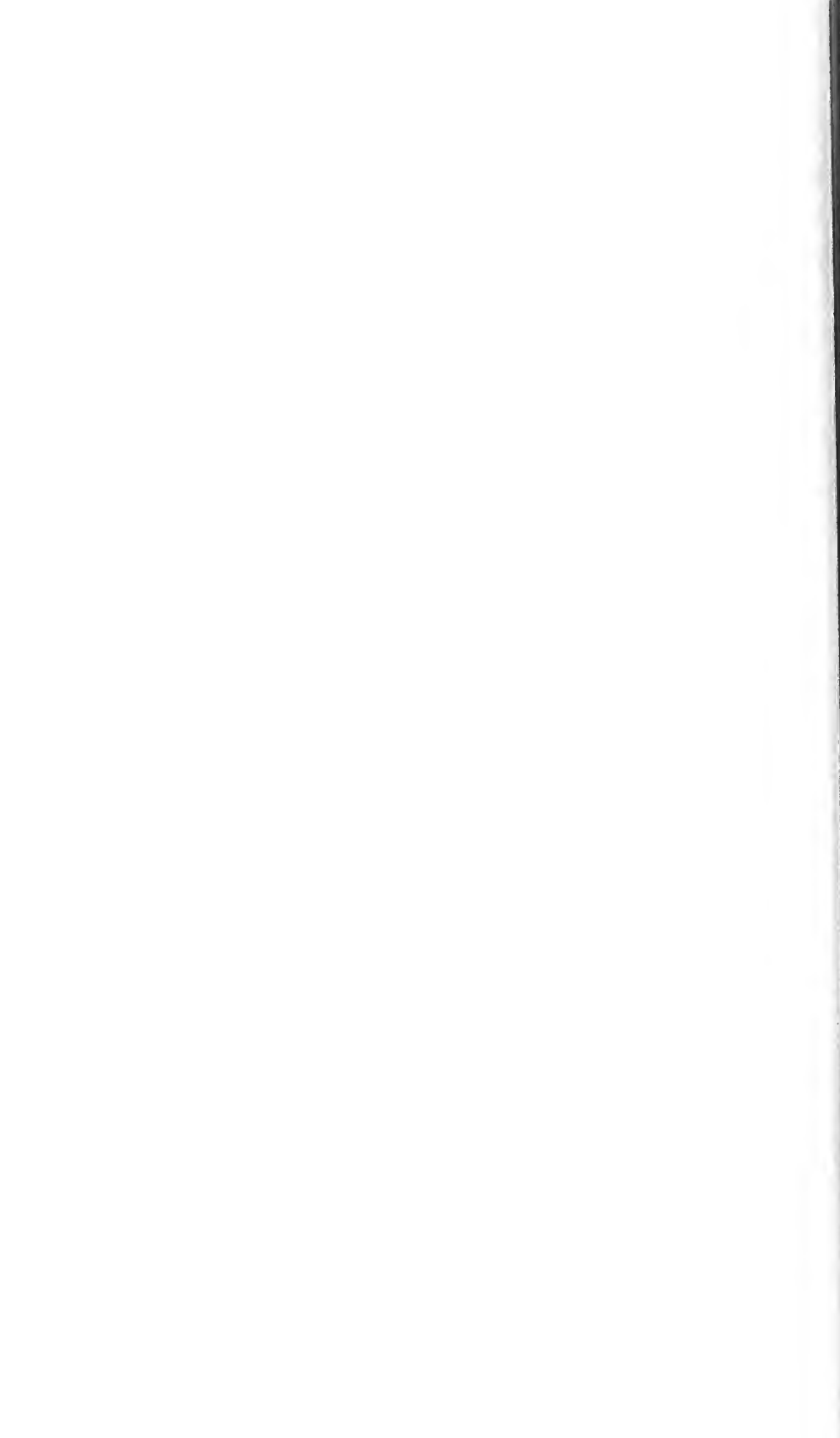
2. Plaintiff's counsel concede (Memorandum filed 8/30/68 p. 8) that they had evidence at the trial that the Harris Upham supervisory practices had been criticized by NYSE. Their complaint is merely that they had not been able to obtain evidence that the firm had been "actually disciplined."

The evidence upon which this court reached its conclusion on the subject of exemplary damages is fully set forth in this court's Memorandum of Decision of March 22, 1968. The judgment entered thereon should stand—subject only to appellate review.

Dated: September 25th, 1968.

/s/ W. T. SWEIGERT

United States District Judge



No. 23018

United States
COURT OF APPEALS
for the Ninth Circuit

RIZAL COMMERCIAL BANKING CORPORATION,
a corporation,

Appellant,

v.

NED PUTNAM,

Appellee.

BRIEF OF APPELLANT

*Appeal from the United States District Court
for the District of Oregon*

THE HONORABLE JOHN F. KILKENNY, Judge

FILED

SEP 20 1958

WM B LUCK CLERK

LINDSAY, NAHSTOLL, HART, DAFOE & KRAUSE
ALLAN HART

9th Floor, Loyalty Building
Portland, Oregon 97204

Attorneys for Appellant



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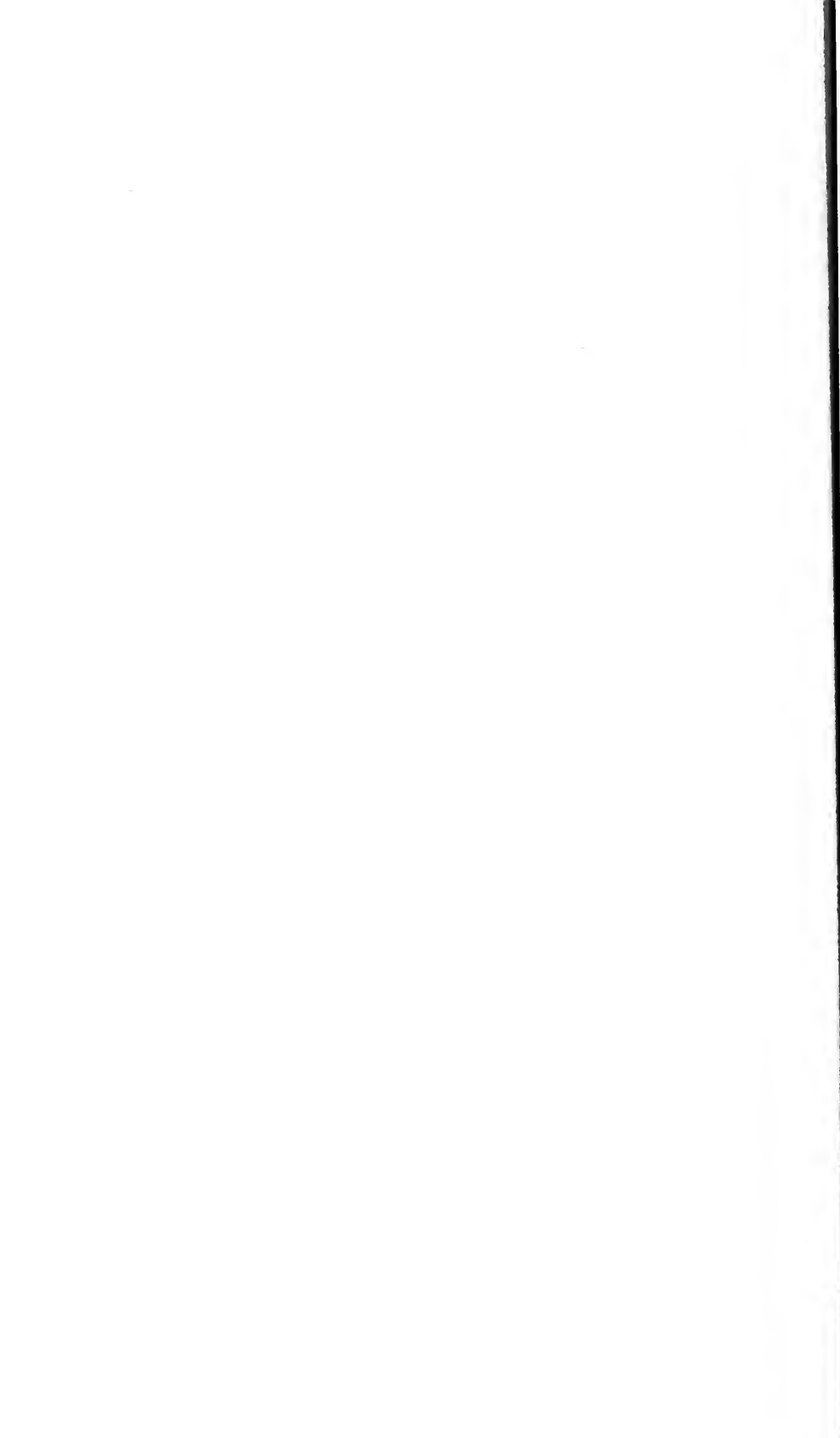
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No. 23018

United States
COURT OF APPEALS
for the Ninth Circuit

RIZAL COMMERCIAL BANKING CORPORATION,
a corporation,

Appellant,

v.

NED PUTNAM,

Appellee.

BRIEF OF APPELLANT

*Appeal from the United States District Court
for the District of Oregon*

THE HONORABLE JOHN F. KILKENNY, Judge

STATEMENT OF THE ISSUES PRESENTED

The issues presented by this appeal are:

Did the Court err in denying plaintiff's motion for a directed verdict, and in submitting the following issues to the jury:

(1) whether there was "cause," or considera-

tion, for defendant's execution of a certain instrument of guaranty; and

(2) whether defendant executed the instrument of guaranty through a "mistake,"

and in denying plaintiff's subsequent motion to set aside the verdicts and judgment for defendant, and to enter a judgment in favor of plaintiff for \$231,142.77; said motions having been on the ground that, viewing the evidence and inferences in the light most favorable to defendant, a judgment for plaintiff in at least this amount was the only conclusion that could be reached as a matter of law; and

Did the Court err in denying plaintiff's motion for a new trial, said motion being on the ground that the verdicts for defendant were against the clear weight of the evidence; and was the Court's denial of this motion, on the ground stated by the Court, an abuse of discretion justifying review on appeal?

STATEMENT OF THE CASE

1. Nature of the Case; Proceedings and Disposition in the Trial Court.

This is an action by plaintiff Rizal Commercial Banking Corporation ("the Rizal Bank" or "the Bank"), a Philippines corporation, to recover from defendant Ned Putnam, as a guarantor thereof, the amounts which the Bank had loaned to Big Chrome Exploration Co., Inc. on a certain deferred letter of credit. The amount for which the complaint sought

judgment was \$269,673.70; but this was increased by the accrual of additional interest, and reduced in response to various rulings of the Court during the trial, and the amount of the claim as sought in the Motion for Judgment Notwithstanding the Verdict was \$231,142.77.

The case was tried to a jury on January 11, 12 and 13, 1968, before the Honorable John F. Kilkenny, District Judge. At the conclusion of the testimony plaintiff moved for a directed verdict, and also for orders withdrawing each of the issues respectively, including the issue of "cause" or consideration and the issue of mistake, from the jury. The defendant made similar motions on defense issues. Rulings on the motions for directed verdicts were reserved, the other motions were denied, and the case was submitted to the jury. The jury returned general and special verdicts for the defendant, and judgment was entered thereon on January 13, 1968. On March 14, 1968 the Court denied plaintiff's Motions for Judgment Notwithstanding the Verdict and for a New Trial, and this appeal followed.

2. Statement of the Facts.

Because of the nature of the issues presented on this appeal, as stated above, we deem it necessary to include in the following factual narrative sufficient detail to show Mr. Putnam's business background and experience, and the extent of his total involvement in the transaction giving rise to the guaranty.

Defendant Putnam is a resident of Klamath Falls, Oregon, where he attended the public schools and then entered business. His primary occupation was as a logging contractor, but he was also engaged in the construction business, and he was part owner of a sawmill. In the construction field Putnam contracted and built buildings, helped construct the Canada-California gas line, etc. (Tr. pp. 143, 190). In 1953 he put some money into a metallurgical chrome mine venture in Northern California, and provided trucking services for the mining operation, but did not otherwise participate in the mining operation (Tr. pp. 149, 191-2).

In the course of his logging, construction and trucking activities Putnam acquired a substantial amount of heavy equipment, including an airplane for his own use. He owned and operated a machine shop that was capable of doing major overhaul jobs on heavy equipment and of fabricating and manufacturing specialized equipment (Tr. p. 153).

At the time of the trial Putnam had acquired interests in several plantations in the Philippines, with avocados as their primary product (Tr. p. 191). In 1966 he had negotiated with the National City Bank of New York for financing of his Philippines ventures (Tr. pp. 188-9).

Early in 1963 Putnam decided to sell his logging and other equipment. With this in mind he visited several Pacific Coast cities making inquiries about the market for used equipment. In San Francisco he

talked to Wayne Fogelstrom, a vice president of Discal Corporation ("Discal"). Discal is an exporter of machinery and equipment, and has a branch office in Manila. Fogelstrom advised Putnam that the best market for his machinery would be in the Philippines (Tr. pp. 143-5).

Acting on this recommendation, Putnam went to the Philippines. He arrived in Manila on March 7, 1963, and worked for three weeks on the sale of his equipment. In the latter part of March he met Fogelstrom in the Manila Hotel, and talked with him about the terms on which Discal would handle the equipment in the Philippines (Tr. pp. 146, 193). Through Fogelstrom, Putnam became acquainted with Bernabe Ang, an employee in Discal's Manila office, and Jose Robles. Robles was president and Ang was vice president of Big Chrome Exploration Co., Inc. ("Big Chrome").

Early in April, during a luncheon conversation about mining in the Philippines, Ang and Robles told Putnam and Fogelstrom about a refractory chrome mine that Big Chrome was attempting to finance and develop. This mine, located a few hours drive from Manila, contained commercial grade ore, but had never been operated, except by crude hand methods (Tr. p. 150). Learning of Putnam's acquaintance ten years earlier with a metallurgical chrome mine in Northern California, Ang and Robles urged him to visit the Big Chrome mine, and to recommend suitable equipment and procedures for operating it (Tr. pp. 148-9, 193).

Putnam at first refused to make the trip to the mine; but during April Ang and Robles continued to talk to Putnam and Fogelstrom about Big Chrome. From later developments, to be set forth hereinafter, it is apparent that it was soon recognized that a substantial part of Putnam's logging and construction equipment would be suitable for use in operating Big Chrome's mine, and that Discal would be interested in selling other needed mining equipment to Big Chrome. Big Chrome clearly could not itself obtain bank financing, but if Putnam and Fogelstrom would obtain a \$300,000 letter of credit for Big Chrome, Big Chrome could purchase some of Putnam's equipment and other equipment from Discal, for \$300,000. In addition, however, either at the same time or soon thereafter, it was apparently further proposed that Putnam and Fogelstrom put some money into Big Chrome and undertake the actual field management of its mining operations, in return for a share of its expected profits.

While these plans were evolving, Putnam continued to resist the urging that he visit the Big Chrome mine, saying that he wanted to get back to the States, where he still had logging operations going near Klamath Falls. But Putnam admittedly was interested in the Big Chrome proposal, if open pit mining would be feasible; he wasn't interested in a tunnel operation (Tr. pp. 150-151).

In the middle of April, Ang first called on the plaintiff Rizal Bank and inquired about a \$300,000

letter of credit for Big Chrome. Plaintiff was a new bank, having opened for business only three months earlier, on January 2, 1963. Ang was known to the Bank officials because he was an officer of another Bank client (Tr. pp. 49, 50).

At the Bank Ang talked to Daniel Chiong, who was then an assistant vice president in the credit department (Tr. p. 48). Ang told Chiong that Big Chrome might be interested in importing some mining machinery at a cost of more than \$300,000, to be paid in installments, and he asked Chiong on what terms the Bank would grant Big Chrome a deferred letter of credit to finance the transaction. Chiong answered that the Bank would of course require collateral, and a "marginal" deposit in an unstated amount; and, since Big Chrome was not in operation, a personal guaranty by a responsible guarantor. In this connection Ang told Chiong that a financier was interested in Big Chrome, but he did not then mention Putnam or Fogelstrom by name. At the conclusion of the conference, Ang said that he and his associates would study the Bank's conditions as stated by Chiong (Tr. pp. 49-51).

Putnam testified that on the last weekend before he left the Philippines, he finally consented to visit the Big Chrome mine (Tr. p. 149). Since he left the Philippines on May 5, this would place his visit to the mine on April 27 and 28.

Robles, Ang, Putnam and Fogelstrom made the trip to the mine. Putnam took samples out of the tun-

nel and from the face of the mine, and studied the terrain to see what would be the best method of operation (Tr. p. 150). He apparently concluded that open pit mining would be feasible.

After returning to Manila, Putnam and the others discussed the Big Chrome venture every day, usually at lunch, and Putnam talked with Fogelstrom about it at the hotel; but Putnam did not then disclose his plans for operating the mine (Tr. pp. 194, 195).

At about this time, i.e., toward the end of April, Ang returned for his second visit to the plaintiff Bank, accompanied this time by Robles (Tr. p. 55). Ang and Robles named Putnam and Fogelstrom as American financiers intending to finance the operation of the mine. They told Chiong that Big Chrome would be purchasing mining machinery from Discal for \$300,000, that Discal was requiring a 20% down payment, and that the balance of \$240,000 would be payable in six semi-annual installments over a three-year period, with interest due Discal on the unpaid balance. Ang asked Chiong for the final terms on which the Bank would establish a deferred letter of credit covering the \$240,000 that would be payable to Discal in the six semi-annual installments (Tr. pp. 50-53).

Chiong's answer to Ang was that for such a letter of credit the Bank would require a marginal deposit of 25%, or \$60,000; guarantees by Putnam and Fogelstrom, and also by Ang himself, and by his uncle,

Ang Lam; and a chattel mortgage on the mining machinery. Chiong stated that the Bank's management would recommend that its Executive Committee approve a deferred letter of credit on these terms. (Tr. pp. 51-53).

As previously mentioned, Putnam left Manila on May 5, and returned to the United States (Tr. p. 147). He took the Big Chrome ore samples with him to San Francisco to be assayed. The San Francisco assay reports were "pretty much in line" with the reports that Robles had given him (Tr. p. 151).

Putnam immediately returned to the Philippines, arriving back in Manila on May 13 (Tr. p. 196). Upon his return, he went to work on a description of the equipment that Big Chrome would need, and on a plan for the operation of the mine. In the end, he came up with a "flow chart" method of operation. He testified as follows:

"This was a very steep hillside and a very narrow place to get started because very little ore was taken out, and machinery had to be designed to fit in a very narrow space. So I came up with a flow chart for this mine and submitted it to Ang to take to Mr. Robles." (Tr. p. 151).

Putnam's proposal included Big Chrome's purchase and use of some of his own equipment, such as dozers, front-end loaders, and dump trucks, all of which Putnam would sell to Discal, for resale to Big Chrome; other equipment that Putnam would fabricate in his shop at Klamath Falls and sell to Discal

at cost, for resale to Big Chrome; and other items that Discal would locate and acquire from outside sources, for resale to Big Chrome (Agreed Fact No. 5, R. p. 11; Tr. pp. 152, 158-160).

Robles and Ang checked on Putnam's proposal, and found that another chrome mine a few miles away was using the method of operating that Putnam was recommending. Within a very few days, Ang and Robles advised Putnam that they were interested in going ahead in accordance with his recommendation (Tr. pp. 151, 196).

At about the same time, Putnam and Fogelstrom on their part made their final decision to participate in the Big Chrome venture. In explanation of his decision, Putnam said that Ang and Robles "suggested that we go up and stay overnight at the hacienda, and it was a nice, relaxing place to stay"; and further,

"Well, I was interested in putting this mining machinery together. I could manufacture and put together this full operation the way it was laid out. My logging operations were being curtailed in Klamath Falls, and it would give me extra men in my shop to put this machinery together. So I consented to put this package together for Discal." (Tr. p. 153).

Putnam apparently went to work immediately on a detailed description and listing of the equipment that Big Chrome would need pursuant to his plan of operations, and on pricing each individual item. Fogelstrom worked with him on pricing the equipment

that Discal would be purchasing from other sources, and also made suggestions as to what would be needed (Tr. p. 152). The listing and pricing of the equipment were "pretty much agreed upon" by June 8, when Putnam again left Manila to return to the United States (Tr. pp. 200, 201).

In the meantime, however, the parties had a formal written contract prepared. This contract, entitled "Agreement," was executed on June 7, 1963, and will be found as Exhibit 1 in the record of the trial of this case. Because of its importance, we summarize its pertinent provisions as follows:

The Agreement began by reciting that Big Chrome ("First Party") needed to purchase and import "machineries and equipment" in the amount of \$300,000, that Putnam and Fogelstrom ("Second Parties") "are desirous to work and are willing to undertake the field management and production aspect" of Big Chrome's mining operations, and that Big Chrome "is agreeable to let the Parties of the Second Part take over the field management operations." Following these recitals, the first four paragraphs of the Agreement were as follows:

"FIRST: That the PARTIES OF THE SECOND PART shall undertake the field operations of said mineral properties subject to the overall supervision of the PARTY OF THE FIRST PART;

"SECOND: That the PARTIES OF THE SECOND PART shall secure credit accommodations from a local bank to enable the PARTY OF

THE FIRST PART to open a Letter of Credit in the amount of US \$300,000.00 for the importation of machineries and equipment needed in the operations and productions of the above properties, from DISCAL CORPORATION, 319 Pacific Avenue, San Francisco 11, California, U. S. A.;

“THIRD: That for purposes of the importation of the machineries and equipment referred to above, the PARTIES OF THE SECOND PART will pay on their own account the amount of US \$60,000.00 as marginal deposit for said letter of credit;

“FOURTH: That the PARTIES OF THE SECOND PART shall make arrangements with the local bank concerned that the balance of US \$240,000.00 shall be liquidated by the PARTY OF THE FIRST PART on deferred payment basis for a period of THREE (3) YEARS, payable in equal semi-annual installments with interest at 7% per annum, plus bank charges.”

In other pertinent provisions of the Agreement, Putnam and Foglestrom guaranteed to produce not less than 5,000 tons of chromite ore per month, commencing within 90 days after arrival of the mining machinery at the mine site, subject to force majeure exceptions (Par. 5); the parties agreed that the first 50% of net profits would be applied to liquidate the bank loan, and Putnam and Fogelstrom would receive 20% of the remaining 50% of the net profits, but after repayment of the bank loan, Putnam and Fogelstrom would receive 20% of all the net profits

(Par. 7); Putnam and Fogelstrom would have a five-year option to buy up to 20% of Big Chrome's stock, after a proposed recapitalization (Par. 8); in the event of the exhaustion of the initial operating funds, Putnam and Fogelstrom "shall arrange the necessary financing needed to continue the operations," which financing "shall be considered as a loan to the Corporation," to be repaid on terms to be agreed upon by the parties (Par. 11); and the Agreement "shall be for a term of ten years from execution thereof" (Par. 13).

The Agreement was executed for Big Chrome by Robles, in Ang's presence, and by Putnam and Fogelstrom individually.

As mentioned above, Putnam left Manila to return to the United States on June 8, 1963, the day after the above Agreement was executed (Tr. p. 201). Fogelstrom apparently remained in Manila and continued with the listing and pricing of the equipment that Discal would sell to Big Chrome.

On June 24, 1963, Discal's invoice to Big Chrome was completed and executed. Its first nine pages list a total of 70 individual items, and assign a specific price to each item. The total of the specific prices, as shown at the bottom of page 9, is \$300,039.78.* Page

* With respect to the specific prices set forth in the above invoice, it is proper to note that many of the items of equipment had not yet even been purchased or manufactured, major overhauls were to be performed on most of the used equipment, including Putnam's, and the costs of crating for shipment, and of the freight from Portland to Manila, were as yet

10 of the invoice is entitled "Deferred Payment Schedule." This Schedule shows the above purchase price of \$300,039.78, and the deduction therefrom of the proposed 20% down payment, or \$60,007.96, leaving an unpaid balance of \$240,031.82; and it then lists the amounts of each of the six semi-annual installments by which the said balance of \$240,031.82 was to be paid. The Schedule specifies that the first installment would be due "6 mos. after comp. shipment," and the remaining installments would be due semi-annually thereafter. Each installment would include interest at 7% on the current unpaid balance, the total of these interest charges being \$29,403.88. Thus after making the 20% down payment, Big Chrome's total indebtedness to Discal would be \$240,031.82 as the balance of the purchase price, plus interest in the sum of \$29,403.88, or a total of \$269,-

unknown. Therefore the exact prices to be charged Big Chrome for the individual items of equipment could be no more than rough estimates. As Putnam testified,

"When you are estimating machinery and you have no idea of the full details, there is no blueprint for any of this machinery, you can't pin everything down to every bearing and every shaft. You have to guess at these things and you try to arrive at a price you can live with, if you are going to put something together." (Tr. 197)

By seeming coincidence, however, the total of the individual prices arrived at by the above process, i.e., the above sum of \$300,039.78, was within \$39.78 of the purchase price that Ang had quoted to plaintiff Bank in the middle of April, and that had also been agreed upon in the June 7, 1963 Agreement. This suggests the likelihood that the individual prices were fixed at a level designed to support the pre-determined total price of \$300,000. During the cross-examination of Putnam, the trial court refused to allow plaintiff to attempt to establish that many of the specific prices were *grossly* excessive (Tr. 202).

435.70. (As will be noted below, the Discal invoice is attached to and is a part of Exhibit 6).

The machinery, equipment and tools listed in the Discal invoice are referred to hereinafter as "the mining machinery."

During this period Putnam was in Klamath Falls, preparing the mining machinery for Big Chrome. He started on his own equipment, without purchasing any outside equipment. Later he purchased various items from machinery dealers or private individuals. Also some of the equipment that Discal obtained was shipped to Klamath Falls, to be incorporated in the construction of the special-design equipment that Putnam was building. Putnam's work along these lines began when he returned from Manila shortly after June 8, and continued for several months (Tr. pp. 158, 159).

It is an Agreed Fact that on or about July 16, 1963, Putnam made a cash contribution of \$48,000 to Big Chrome, and Fogelstrom contributed an additional \$48,000. Putnam sent his payment to Fogelstrom, who transmitted the total of \$96,000 to Ang (R. p. 11).

Putnam explained that while he was in Klamath Falls working on the mining machinery he received a telephone call from Fogelstrom, who said that he had had word from Ang that Ang had been able to negotiate a letter of credit and was going to need the money for the marginal deposit that was a condition of its issuance (Tr. p. 210). Presumably Fogelstrom

told Putnam that the marginal deposit would have to be increased from \$60,000, as provided in the June 7, 1963 Agreement, to \$67,358.93 (being 25% of \$269,435.70), and that Big Chrome would need additional funds for moving the machinery to the mining site and assembling it (Tr. p. 155). In any event Putnam agreed to the increase and made his contribution of \$48,000 as stated above.

Upon receiving this money, i.e., at the end of July, Ang returned to the Rizal Bank for a third conference. He told Chiong that Big Chrome and its backers were now ready to agree to the conditions which Chiong had promised would be recommended for the issuance of a deferred letter of credit. Ang gave Chiong a signed copy of the Discal invoice and indicated that the letter of credit should be in the above sum of \$269,435.70, as shown in the Deferred Payment Schedule on page 10 of the invoice, and should be disbursed as also shown on the Deferred Payment Schedule (Tr. p. 57). Chiong agreed to submit this request to the Bank's Executive Committee.

On July 30, 1963 the Executive Committee approved the Big Chrome letter of credit as recommended (Ex. 2).

On August 2, 1963, Big Chrome executed a formal Commercial Letter of Credit Application and Agreement (referred to hereinafter as "Application and Agreement"), applying to the Bank for an irrevocable letter of credit in Discal's favor for \$269,435.70. The Discal invoice was attached, and for disbursement

instructions the Application and Agreement carried the following notation: "SEE DEFERRED PAYMENT SCHEDULE AS PER ATTACHED FIRM OFFER."

The Application and Agreement was executed for Big Chrome by Robles. Upon its acceptance by the Bank, as noted below, it became the contract between Big Chrome and the Bank. It is Exhibit 6 in this case.

On August 5, however, Robles wrote to the Bank on Big Chrome's behalf, requesting that the 25% marginal deposit of \$67,358.93 be converted to a fixed deposit in the same amount (Ex. 3). A fixed deposit is the same as a time deposit. It carries interest, whereas a marginal deposit does not (Tr. p. 62). On August 6 the Bank's Executive Committee approved of the requested change (Ex. 4).

In a letter to Big Chrome dated August 7, 1963 (Ex. 5), the Bank stated that Big Chrome's Application and Agreement had been approved subject to the following conditions:

- "1. Chattel mortgage on all the imported mining machinery, tools and equipment valued for \$300,039.78;
- "2. 20% down-payment on C & F Manila price upon placing of order or \$60,007.96;
- "3. To deposit in our Bank in the form of time deposit the equivalent of 25% ;
- "4. Subject to the joint and several signatures of Ang Lam, Bernabe Ang, Wayne Fogelstrom, and Ned Putnam; and

- “5. Payable in three (3) years with semi-annual payments—failure to pay any one installment makes the account due and payable in full.”

On the following day, August 8, 1963, Big Chrome deposited \$67,358.93 with the Bank as a one year time deposit, (Ex. 7), and the Bank issued its irrevocable deferred Letter of Credit No. 63/252. The Letter of Credit was addressed to the Crocker-Anglo National Bank in San Francisco, and authorized the Crocker Bank to honor Discal's six drafts in the amounts and on the dates set forth in a schedule on the face of the Letter of Credit. This schedule was identical with the Deferred Payment Schedule on page 10 of Discal's invoice. Thus the first draft was to be dated six months after “complete shipment” of the mining machinery, and the other drafts were to be dated semi-annually thereafter; and the total of the six drafts was \$269,435.70. The Letter of Credit is Exhibit 8 in this record.

During August, September and October Putnam continued to work on the mining machinery in Klamath Falls. In September he made a quick trip to Manila, but he testified that this was regarding another deal on his logging machinery (Tr. p. 211).

When Putnam had the mining machinery ready, he crated it and moved it to Portland. Some of the items purchased by Discal were sent directly to Portland (Tr. pp. 158, 159). Loading of all of the mining machinery on board the SS “Manilla” was completed

at Portland on November 16, 1963, and a bill of lading and other customary shipping documents were thereupon issued (Agreed Fact No. 5, R. p. 13). The bill of lading (Ex. 9) carried an endorsement as follows: "*Laden on board vessel Nov. 16, 1963.*" This fixed the date of Discal's first draft as May 16, 1964, and the dates of the remaining drafts were November 16, 1964, May 16, 1965, November 16, 1965, May 16, 1966, and November 16, 1966 (See Ex. 12).

The shipping documents were forwarded to Discal in San Francisco. Upon receiving them, Discal took them to the Crocker-Citizens (formerly Crocker-Anglo) National Bank, where they were apparently found to be in proper order. Discal then took Letter of Credit No. 63/252 to the Pacific National Bank of San Francisco. Pacific National discounted the Letter of Credit, and Discal thereupon received payment of the sum of \$269,435.70, less the discount (Agreed Fact No. 14, R. p. 13). Subsequently Putnam was required to, and did, guarantee the Letter of Credit (Tr. p. 212).

After moving the mining machinery to Portland, Putnam sent Discal an invoice covering the items he was selling to Discal for resale to Big Chrome, the items he had manufactured as specially designed equipment, and his work in crating the mining machinery and moving it to Portland. He testified that he invoiced his equipment to Discal at what he deemed its retail value less 20% ; he invoiced equipment that he purchased for Big Chrome at the cost he paid for

it; and he invoiced his shop work, crating, shipment to Portland, etc., at cost. On none of these items did he charge for his own time (Tr. pp. 160, 161). The total amount shown on Putnam's invoice to Discal was just under \$100,000 (Tr. p. 160). Discal paid this amount to Putnam shortly after Discal received the proceeds of Letter of Credit No. 63/252 from the Pacific National Bank (Agreed Fact No. 14, R. p. 13).

In the due course of business the Crocker Bank forwarded the shipping documents to the Rizal Bank, which received them on December 5, 1963 (Agreed Fact No. 15, R. p. 13). At that time the SS "Manila" was still at sea. It docked in Manila on about December 24, 1963 (Agreed Fact No. 18, R. p. 13).

Putnam arrived back in Manila on December 1, 1963. About a week later, Ang called the Rizal Bank and asked Chiong if the Bank had received the shipping documents. Chiong answered that the Bank had the shipping documents in its possession, and would deliver them to Big Chrome on a trust receipt after Putnam and Fogelstrom signed first their personal guaranties, these guaranties being agreed conditions on which the Letter of Credit had been issued. Ang made an appointment to bring Putnam and Fogelstrom to the Bank on December 13, to sign their guaranties (Tr. p. 66).

We come now to the crucial events of December 13, 1963.

At the trial, Chiong, who had become a Vice President of the Rizal Bank in charge of the Foreign De-

partment (Tr. p. 48), testified that on the morning of December 13 Ang, Putnam and Fogelstrom came to his office. Chiong told them that the "joint and solidary" guaranty of Putnam and Fogelstrom was required as one of the conditions on which the Executive Committee had approved the Letter of Credit (Tr. pp. 67, 88). Putnam and Fogelstrom acquiesced, so Chiong asked them to step into the office of Rudolfo Pineda, the Bank's attorney (Tr. p. 67).

Pineda is an attorney admitted to the Philippine Bar, and is Corporate Secretary and Resident Counsel of the Rizal Bank (Tr. pp. 96, 97). He testified that when Ang, Putnam and Fogelstrom came to his desk on the morning of December 13, Ang introduced Putnam and Fogelstrom to him. Pineda picked up the proposed Undertaking from his desk and said to Putnam and Fogelstrom:

"This is an undertaking that will make you jointly and severally liable for the account of Big Chrome, so you may read it for yourself."

Pineda handed the Undertaking to Putnam and Fogelstrom, *both of whom read it*. Then they gave it back to Pineda, and he gave it to his secretary to fill in the blanks. While this was being done, Pineda asked Putnam and Fogelstrom for their passports so that he could place certain required information in the acknowledgment. After the secretary had the Undertaking ready, Pineda again handed it to Putnam and Fogelstrom, and asked them if they understood what it was. They said "yes," and then signed the

Undertaking, and Pineda completed the acknowledgment (Tr. pp. 98, 99, 113).

The Undertaking is Exhibit 10 in this record. Because of its importance it is quoted in full in an appendix to this brief (*infra*, App. p. 1).

Putnam's version of these events differed slightly, but significantly.

Putnam testified that on the morning of December 13 he came back to the hotel after attending to some other business, and found that Ang and Fogelstrom were looking for him.

"They said that we had to hurry and go out to the Rizal Bank; there were some papers out there that would have to be signed in order to allow Big Chrome to get the shipping documents so they can get their Customs clearance and their tax exemption." (Tr. p. 163).

Putnam admitted that he did not know why his signature would be required in order to enable Big Chrome to get the shipping documents, since he was not an officer of Big Chrome; but he went to the Bank with Ang, Fogelstrom and another Discal staff member (Tr. pp. 163, 164, 217).

Putnam's testimony was that when he and the others reached the Bank they went only to Chiong's office. Putnam did not recall going in to Pineda's office to sign the Undertaking, but he said that Pineda's office was across the hall, and "we were back and forth between the two rooms." (Tr. pp. 164, 216).

On his direct examination Putnam testified that Chiong was busy on the telephone when the Big Chrome group entered his office, but he picked up a file from his desk and found the papers he wanted signed. When he finished his telephone conversation, "he took out these papers and asked us to look at them and sign them." (Tr. p. 164). Putnam's direct examination continued as follows (Tr. pp. 164-166):

"Q. Did you read the papers?

A. I glanced at the top, and it said 'Undertaking.' I never read the whole thing, because they told me that this was a necessary thing, and everybody else signed, so I figured if they had the nerve to do it, why, I also did.

Q. You didn't read the whole document?

A. No, I didn't. This document—the way the thing started out, it looked to me like a document to give them the right—if I had any rights against this shipment it would give them the right to have these documents to take from the bank and do what they had to do with them.

.

Q. Who was it that told you it was all right to sign?

A. Mr. Fogelstrom.

Q. And you say he had already signed at that point?

A. Yes. I was the last to sign."

During his cross-examination Putnam supplied the following additional information (Tr. 217):

"THE COURT: Mr. Putnam, did you read the instrument?

THE WITNESS: No, I didn't. I only glanced at the top."

By Mr. Hart:

"Q. Did you have time to read the document?

A. I probably could have taken time to if I had wanted to."

The foregoing is the testimony on the basis of which Putnam contends that he signed the Undertaking by mistake.

After execution of the Undertaking by Putnam and Fogelstrom, the Bank's remaining requirement was the lien it was to have on the mining machinery. The agreed condition of the Letter of Credit was that the Bank was to have a chattel mortgage (Ex. 5). However Big Chrome was not yet in a position to execute a chattel mortgage, because it did not yet have possession of the machinery and equipment (which was still at sea) or even of the shipping documents, which the Bank would not release until it obtained a lien in some form. Under Philippines law a chattel mortgagor must be in possession of the chattels (e.g., see Ex. 16), and indeed, the execution of a chattel mortgage is ordinarily deferred until the mortgagor not only has possession of the chattels, but has moved them to the Province where they are to be installed, because the chattel mortgage is required to be registered in the registry of deeds in that Province (Tr. pp. 100, 115-117). Chiong testified that in these circumstances the usual banking practice when merchandise is being imported on an open letter

of credit is to release the shipping documents on a trust receipt, so that the client can gain possession of the merchandise and move it to the location where it is to be installed, and then to have the chattel mortgage executed and registered* (Tr. p. 60).

Accordingly the Bank requested Big Chrome to execute a trust receipt covering the mining machinery, and indicated that it would deliver the shipping documents to Big Chrome after this was done (Tr. p. 68). This was agreed to, and on December 16, 1963 Ang and Robles came to the Bank and executed a Trust Receipt as requested, and the shipping documents were thereupon handed to them (Agreed Fact No. 17, R. p. 13; Tr. pp. 100, 113, 114). It was understood that Big Chrome would execute a chattel mortgage after the mining machinery arrived at the mine site.

As previously mentioned, the mining machinery arrived in Manila on or about December 24, 1963, and Big Chrome was able to and did take possession of it (Agreed Fact No. 18, R. p. 13). By this time Putnam had returned to Klamath Falls for the holidays but he had left instructions for the unloading and handling of the machinery (Tr. p. 167).

* This use of a trust receipt is to be distinguished from the use of such an instrument on a sight letter of credit. In the latter case the trust receipt is used for the bank's protection when the bank is extending credit by allowing its customer 60 or 90 days for repayment of a draft. Such an extension of credit to Big Chrome on a trust receipt was forbidden by the Rizal Bank's Executive Committee, see Exhibit 2, and this resulted in some confusion in the record (Tr. pp. 58, 90, 91).

Putnam returned to Manila on January 10, 1964, and found that his instructions for the handling of the mining machinery had not been carried out (Tr. pp. 168, 169). This appears to have been the beginning of Putnam's troubles with Big Chrome. These troubles increased during the next two months, after the mining machinery finally reached the hacienda near the mine site. Putnam testified that Big Chrome did not find skilled workmen for him, and diverted workers from other projects, etc. (Tr. pp. 170, 171). After about a month, Big Chrome's funds were exhausted, and Putnam and Fogelstrom each contributed an additional \$8,500, but this total of \$17,000 only lasted three or four weeks (Tr. p. 156). By early March, Big Chrome's funds were again exhausted, and Putnam was completely frustrated. On March 2, 1964 he left the area in anger and quit the venture (Tr. p. 170).

A few days later Putnam met with Ang, Robles and Fogelstrom in Big Chrome's Manila office, but nothing was accomplished there except more arguments, and Putnam walked out of the meeting (Tr. p. 173).

Later Ang and Fogelstrom came to the hotel and tried to soothe Putnam and persuade him to stay in the venture. Among other things, "they told me that I was implicated in this thing as a guarantor, and I would have to stay with the operation and see it through." Putnam claims that this was when he first learned that he was a guarantor of Big Chrome's liability to the Rizal Bank (Tr. p. 171).

After Putnam's departure, the Big Chrome project was in effect abandoned by the other participants. The mining machinery was allowed to stand idle at the mine site. No mining was ever done.

Putnam testified that he returned to the Rizal Bank shortly before the date on which Discal's first draft was due to be presented, and told Chiong that there were problems and friction in Big Chrome, that the mining machinery was not being put together on schedule, and that he couldn't see how the Bank was going to get paid for this first installment. Chiong answered that Big Chrome had applied to the Development Bank of the Philippines ("DBP") for outside financing, and that he thought this financing would be accomplished (Tr. p. 174).

On May 15, 1964, Pineda wrote to Big Chrome, asking for prompt execution of the chattel mortgage (Ex. 15A).

On May 16, 1964, Discal's first draft was presented to the Crocker-Citizens National Bank in San Francisco, and after payment from the Rizal Bank's funds, was forwarded to the Rizal Bank, which received it on May 27, 1964 (Ex. 12). On May 29, 1964, the Bank sent its statement to Big Chrome for the amount advanced on this draft (Ex. 13). Chiong explained that under Philippines banking practice, and the Rizal Bank's policy, the amount shown on the statement was immediately due, and became delinquent after 30 days. Therefore the May 29, 1964 statement became past due 30 days later, on June 28, 1964 (Tr. pp. 72, 73).

Each of Discal's remaining drafts was presented and forwarded in the same way, and the Rizal Bank sent similar statements to Big Chrome. See Exhibits 12 and 13.

Pineda wrote to Big Chrome again on June 10, 1964, again asking for execution of the chattel mortgage, and also requesting payment of the amount that became due on May 29, 1964 (Ex. 15b).

On June 28, 1964, when Big Chrome failed to pay the amount due on the May 29, 1964 statement, and the account became "past due," Chiong turned the file over to the Bank's Legal Department, and thereafter Pineda handled the Bank's claim against Big Chrome (Tr. pp. 73, 74).

Neither of Pineda's above letters was answered. However, early in September Robles came to the Bank, and Pineda prepared the chattel mortgage. This was executed by Robles for Big Chrome on September 10, 1964, and was duly registered by Pineda (Tr. pp. 102, 103). The chattel mortgage is Exhibit 16 in this record.

On October 2, 1964, Pineda wrote to Big Chrome asking for prompt payment of the amount due (Ex. 17a). Robles replied on October 14, stating that Big Chrome's application for a DBP loan was pending before the DBP Board of Governors, and therefore asking the Rizal Bank for more time (Ex. 17b).

On October 19, Putnam called on Fernando E. V. Sison, the president of the Rizal Bank, to find out

what was going on with Big Chrome. Sison mentioned Big Chrome's DBP application, and Putnam then told him that he didn't think the DBP application was going through, and was being used by Big Chrome as an excuse. Sison immediately called the DBP, and learned that Big Chrome's application had been rejected about a month previously (Tr. pp, 105, 106, 175). Sison instructed Pineda to write to Big Chrome for an explanation, which Pineda did the same day (Ex. 17c); and Sison also asked Putnam to bring Ang to the Bank for a conference. Putnam and Ang came in a few days later, and Sison scolded Ang for Robles' misrepresentation of the status of the DBP application (Tr. pp. 105, 175).

Putnam was asked why he made these visits to the Bank to inquire about Big Chrome. His answer was as follows:

"Well, I felt like I had an obligation to put that machinery together, and I felt that some day my machinery would be sold, and I would have no further business in the Philippines, and I didn't want anything hanging over my head—an obligation to take care of in the Philippines." (Tr. pp. 175, 176)

In answer to Pineda's request for an explanation about Big Chrome's DBP application, Robles wrote to the Bank on November 13, 1964, explaining that Big Chrome had been advised by a DBP official to refile its application, which Big Chrome had now done, and accordingly Robles again urged the Bank "to extend us further consideration by not pressing

us for payment of our account at this time that we are in a transition period." (Ex. 17d). In reply Sison gave Big Chrome an additional month (Ex. 17e).

Robles wrote to the Bank again on November 27, 1964, stating that Big Chrome now had other financing under negotiation, in addition to its DBP application, and asking the Bank to consent to a second mortgage on the mining machinery (Ex. 17f). Sison gave the Bank's consent to this (Ex. 17g).

On February 15, 1965, Robles advised the Bank by letter that Big Chrome's DBP application was being reconsidered, and he enclosed copies of Big Chrome's correspondence with its other prospective financier, and asked the Bank "to bear with our situation a little while longer." (Ex. 17h). Pineda's answering letter, dated February 24, 1965, asked Big Chrome to submit a definite proposal or enter into a satisfactory arrangement with the Bank within 30 days (Ex. 17i).

Pineda's correspondence with Big Chrome along these lines continued for several more months. In his letters Pineda repeatedly threatened to forward the Big Chrome account to the Bank's general counsel for legal action; and in reply, Big Chrome reported progress in its efforts to obtain refinancing, and asked for more time within which to accomplish this (See Ex. 17j through 17t).

The final letter in this correspondence was Big Chrome's letter to the Bank dated January 24, 1966 (Ex. 17u). In this letter Big Chrome stated that it

was preparing a 1,000-ton shipment of ore, from the proceeds of which the Bank would receive a substantial payment. Upon receiving this letter Pineda called the Continental Ore Company, which was understood to be the purchaser of this alleged shipment. Continental advised Pineda that there would be no shipment. Pineda reported this to Sison, and it was decided that the time had come to forward the Big Chrome account to Alberto Meer, a Manila attorney and the Bank's general counsel, for appropriate court action (Tr. p. 111).

Before this was done, however, the Bank on March 8, 1966 took over Big Chrome's time deposit, which was in the sum of \$67,358.93, plus accrued interest of \$7,401.79, or a total of \$74,760.72 (Ex. 18; Tr. pp. 74, 75). This latter amount was applied to the reduction of Big Chrome's liability arising out of the Letter of Credit (Agreed Fact No. 22, R. p. 14).

Attorney Meer testified that the Big Chrome account was referred to him in March, 1966. Upon receiving the file, he studied the strategy and procedure to be adopted, asked for up-to-date credit reports on the guarantors, corresponded with law firms in San Francisco and Portland, etc. (Tr. pp. 128-130). This work continued during the spring and summer of 1966.

Meanwhile on August 10, 1966 Putnam, who was then in Manila, apparently wrote to Fogelstrom expressing concern about the likelihood that the Rizal Bank would start legal proceedings. (This letter was

not produced by Putnam, and is not in evidence.) Fogelstrom answered on September 12, 1966, telling Putnam that he was "not too much concerned" about the Rizal Bank (Ex. 20). Continuing, Fogelstrom's letter said:

"I think personally that your best deal would be to stay entirely clear of these people inasmuch as I seriously doubt that they will endeavor to bring a lawsuit against us as a first course of action. Their first course of action, of course, would be through Ben and his guarantors locally, inasmuch as they would be easy to get to. Frankly, I still doubt that they will ever do anything drastic other than possibly take over, foreclose Joe, sell what machinery, etc., is available and then endeavor to collect the balance from the guarantors. I am more concerned about the last payment which is due to the Pacific National Bank against which you and I signed our personal guarantees."

Putnam wrote back to Fogelstrom on September 19, 1966 (Ex. 21), sharply disagreeing with Fogelstrom's above views. In his letter Putnam spoke as follows:

"First off I think that you should go get some legal advice before coming here. If you will remember the Credit was made out to Big Chrome and Joe signed as Pres. and Ben and I think his Father who has since passed away and you and I are the guarantors. This leaves Ben You and I to recover this thing. This is a black mark against my credit here in the Philippines and I will not stand for anyone to try to get out

of this obligation or in anyway cause the Bank any trouble because they went along with us in good faith and have been very lenient. This has been turned over to Att. Alberto Meer to solve. In my opinion some one or a group should take over the whole thing Land and all and operate in order to recover all of the assets because the machinery will not bring enough to cover the obligation. If this is not fully recovered then the bank will come on to us as Ben has nothing and is in very bad shape. We cannot get out of this bill and I will not even try. I think that you should bring all of your correspondence and information pertaining to this case and be sure to bring any information regarding the airplane."

As stated in the above letter, Putnam recognized that Big Chrome's mining machinery would not bring enough to cover the Bank obligation, and that it would be better if a new group took over and operated the mine. Putnam testified that at about this time he was attempting to sell some of his remaining machinery to a man named Pascual, who was associated with the Cabarrus firm, a prominent business "empire" in Manila. Pascual was operating a mine near the Big Chrome property, but was having serious road problems with it. Putnam suggested to Pascual that he abandon his present mine and work the Big Chrome mine instead. Pascual became interested and wanted some ore samples from the Big Chrome mine (Tr. pp. 178, 179).

At about this time Attorney Meer was informed by the Bank that Putnam had requested an appoint-

ment because he had a proposition to make, and Meer was asked to be present at the conference. Meer went to the Bank, where he, Sison, Chiong and Pineda met with Putnam. At this meeting Putnam said that he had some ideas about getting outsiders to join them in the Big Chrome mining venture, and that he might be able to interest Pascual in taking over both the equipment and the mine itself. Putnam asked the Bank to make a credit check on Pascual, and he asked Meer to find out if Pascual was a capable miner, since the Cabarrus firm was a client of Meer's. The Bank officials agreed that Putnam's proposal would bring the best recovery for the Bank, and they assured Putnam of "full cooperation" (Tr. pp. 131, 132, 181).

Following this meeting Putnam brought Pascual and two assistants to Meer's office. Meer repeated the Bank's assurances of cooperation. Pascual said he wanted to visit the Big Chrome mine site, to see the equipment and obtain ore samples. Meer agreed, and instructed Pineda to make all necessary arrangements, which Pineda did (Tr. pp. 132, 133).

However, Pascual's party was unable to get to the Big Chrome mine, due to weather and road problems, and they concluded that they would have to wait until the end of the rainy season, which would not be until January 1967, before making another attempt (Tr. p. 180).

On October 20, 1966, Putnam returned to Meer's office and reported that Pascual had been unable to

get to the Big Chrome mine, and would be unable to do so until after the first of the year. Putnam asked that the Bank not take any drastic action against Big Chrome pending the results of Putnam's negotiations with Pascual. Meer again agreed that it would be in the Bank's interest to transfer the mine and the mining machinery to a new operator, and he said that he would inform the Bank of his conversation with Putnam (Tr. p. 134).

On the following day, October 21, Meer wrote a letter to Putnam, summarizing the above conversation, including Putnam's request that the Bank "defer any drastic action against Big Chrome" pending Putnam's negotiations with Pascual (Ex. 22). Putnam received this letter (Ex. 22a, Tr. p. 137), but did not answer it (Tr. p. 135).

At the trial Putnam, referring to this incident, said that "I don't think I requested him (Meer) to defer any action." But Putnam admittedly received Meer's October 21 letter (Ex. 22a), and did not then or at any time challenge the accuracy of the letter's report that he made such a request.

On November 23, 1966 Meer's law firm sent a formal demand letter to Big Chrome, Robles, Putnam, Fogelstrom and Ang (Ex. 23).

On December 4, 1966 Putnam came to Meer's office again, and said he had another prospect in mind, namely, the Santa Clara Lumber Company. Putnam said that the Santa Clara officials wanted to visit

the mine site and see the mining machinery, and he asked Meer to make the necessary arrangements. Putnam again cautioned Meer that the Bank should not take any drastic action on the Big Chrome matter, because he had others in mind, including some Japanese mining people, who were interested in Big Chrome and were waiting for ore samples, which Putnam would bring to them during March or April (Tr. pp. 135, 137, 138, 182).

Meer called the Bank and arranged for two of its employees to accompany the Santa Clara people to the Big Chrome mine. Nothing came of this, however (Tr. pp. 135, 181, 182).

One final matter must be mentioned.

The mining machinery that Discal sold to Big Chrome included Putnam's Super Cub single-engine airplane. The price shown on the Discal invoice for his airplane was \$5,160. On January 17, 1967, a local creditor of Big Chrome sued in the court for the Province of Rizal and obtained an attachment on the airplane. The Rizal Bank, having a prior lien under Big Chrome's chattel mortgage dated September 10, 1964, duly filed a third party claim in the attachment proceeding, in the sum of 5,160 pesos. Thereafter on January 25, 1967 the Sheriff of Rizal Province sold the airplane at a public auction, and required the purchaser to post a bond for the 5,160 pesos claimed by the Bank. A few days later the Bank filed a "Supplemental Third Party Claim" in the attachment proceeding, claiming \$5,160 instead of 5,160

pesos. However on January 30, 1967 this Supplemental Claim was rejected by the Sheriff because the airplane had already been sold and the bond posted, as stated above. Thereafter the Sheriff remitted 5,160 pesos to the Bank, which applied this sum to the reduction of Big Chrome's liability arising out of the Letter of Credit (Agreed Fact No. 23, R. p. 14; Ex. 19).

Damages. In its Motion for Judgment N.O.V., plaintiff asked for a judgment against defendant Putnam in the sum of \$231,142.77 (R. pp. 44, 45). In computing this sum, plaintiff relied only on evidence which was entirely undisputed; or, where there was a dispute or the possibility of a dispute, on the evidence and inferences viewed in the light most favorable to defendant. The computation is set forth in detail in the Motion (R. p. 45).

The evidence supporting the above computation may be summarized as follows:

It is an agreed fact that \$269,435.70 was paid out on Discal's six drafts (Agreed Fact No. 19, R. p. 13).

In its Application and Agreement (Ex. 6), Big Chrome agreed to pay interest on the following terms:

"For all draft(s) drawn or purporting to be drawn under the credit, to pay to you on demand in Philippines legal currency, the equivalent of the amount(s) of such draft(s) at the rate of exchange you may fix *with interest at the current rate prevailing at the time of negotiation of such draft(s)* from the date(s) of payment or arrival

date of remittance at the place where cover is to be provided." (*Italics added.*)

It is an Agreed Fact (No. 19, R. p. 13) that Dis-cal's six drafts (Ex. 12) were presented to and honored by the Crocker-Citizens National Bank in the amounts and on the dates stated on the face of the Letter of Credit (Ex. 8), the said dates being the semi-annual anniversaries of November 16, 1963, the date on which the shipment of the machinery and equipment was completed. The amounts and dates of the six drafts were as follows:

| | | |
|-------------------|-------------|-------------------|
| First draft | \$48,406.41 | May 16, 1964 |
| Second draft | 47,006.23 | November 16, 1964 |
| Third draft | 45,606.04 | May 16, 1965 |
| Fourth draft.... | 44,205.85 | November 16, 1965 |
| Fifth draft | 42,805.67 | May 16, 1966 |
| Sixth draft | 41,405.50 | November 16, 1966 |

\$269,435.70

Chiong gave the only testimony in the record on prevailing interest rates. He testified that from 1962 until 1964 the interest rate charged by commercial banks in the Philippines was 8%, and this was the rate specified by Rule 21 of the 1962 edition of the Rules of the Bankers Association of the Philippines (Ex. 25). In the latter part of 1964 a tight money situation developed. Beginning at that time, and continuing into 1965, some banks charged 8%, some charged 8½%, and some charged 9%. In 1965 the Bankers Association published a new edition of the Rules (Ex. 26), in which Rule 21 specified a rate of 9 % (Tr. pp. 76-78).

In conformance with the foregoing, the Rizal Bank charged 8% on Discal's first draft, which was the prevailing rate when that draft was negotiated early in 1964 (Ex. 25); 8½% on the second draft, and also on the third and fourth drafts, although the prevailing rate rose to 9% in 1965 (Tr. pp. 76-78); and 9% on the last two drafts, which were negotiated in 1966. Note that the Bank continued to use the 8½% rate on the third and fourth drafts in 1965, even after the 1965 edition of the Bankers' Rules (Ex. 26) called for the 9% rate. The foregoing are the interest rates used in computing the amount of the judgment sought in plaintiff's Motion for Judgment N.O.V. (R. p. 46).

The said computation includes interest on each draft from the date the draft was negotiated (as provided in the Application and Agreement) to January 8, 1968, the date of the pretrial order in this case. This use of the date of the pretrial order for closing the interest computations was as agreed by the parties.

Big Chrome's time deposit was treated in this computation as having been seized and applied to the Letter of Credit account on the date the deposit matured. The defendant contended for this (R. p. 25), and the trial court so ruled (Tr. p. 311).

Also in this computation, credit has been given for the full purchase price of the airplane, \$5,160, although through an apparent error the Bank had claimed and in fact received only 5,160 pesos. The defendant contended for this larger credit (R. p. 25).

Certain additional items which were included in plaintiff's original computation of the amount due, but which were disputed by defendant, have been excluded from this computation. The small items of correspondent's charges, commissions, and documentary stamps, which are the only other items included in the computation, were not disputed in any way.

Verdicts, Judgment, and Plaintiff's Subsequent Motions. At the conclusion of the testimony the Court reserved ruling on the parties' respective motions for directed verdicts (Tr. pp. 304-5, 312), and eliminated certain of the issues stated in the Pretrial Order, (R. pp. 19, 20), from the jury's consideration (Tr. pp. 305-319). For the purposes of this appeal, the only issues submitted to the jury were the following (R. p. 19):

1. Was there a valid cause or consideration for the defendant's execution of the Undertaking?
2. Was the signature of the defendant placed on the Undertaking as a result of a mistake going to the very substance of the subject matter? If so, did he in any event know that Big Chrome's right to obtain possession of the documents was contingent upon his signing the Undertaking?

On these issues the jury returned a general verdict in favor of the defendant (R. 41), and in special verdicts submitted by the Court it found that the Undertaking was not supported by either cause or consideration, and that a mistake was made by the defendant in signing the Undertaking, sufficient to

avoid the Undertaking (R. p. 42). A judgment was entered accordingly (R. p. 43).

Plaintiff duly moved the Court to set the above verdicts aside and to enter a judgment in accordance with plaintiff's motion for a directed verdict, or, in the alternative, to grant plaintiff a new trial on the ground that the above verdicts are against the clear weight of the evidence (R. pp. 44-52).

The Court's order denying the foregoing motions (R. pp. 81-87) is reproduced as an appendix to this brief (Infra, App. p. 7). On plaintiff's motion for a judgment notwithstanding the verdict, the Court held that there was both valid cause and valid consideration for defendant's execution of the Undertaking, and that therefore, the special verdicts to the contrary on these issues could not stand (R. p. 83; infra, App. p. 8). But on the issue of mistake, the Court's ruling was that while the defendant's evidence "is somewhat vague and his line of defense is rather thin," it was "sufficiently clear" to be submitted to the jury under proper instructions, and was so submitted (R. p. 85; infra, App. p. 11). On plaintiff's motion for a new trial, the Court held as follows:

"Plaintiff's alternative motion for a new trial on the ground that the verdicts in this case were against the clear weight of the evidence is addressed to the sound discretion of the Court. While *I personally feel that the weight of the evidence is in favor of plaintiff's contentions*, I likewise feel the evidence on mistake was sufficient to go to the jury. I do not feel that anything

would be gained by granting a new trial. The Court would still be faced with the same legal issues as were raised on the pending motions and in the former trial. *Sooner or later, these problems must be presented to the Court of Appeals. To grant a new trial would only postpone the ultimate conclusions of the Court of Appeals.*" (R. p. 86; infra, App. p. 12) (Italics added).

APPLICABLE LAW

The parties are agreed (R. pp. 21, 25) that this transaction is governed by the Civil Code of the Philippines and the unwritten law of the Philippines. A copy of the Civil Code is in evidence as Exhibit 66, and its pertinent provisions are reproduced in an appendix to this brief (Infra, App. 3).

QUESTIONS PRESENTED

On this appeal the questions presented are the following:

1. Viewing all of the evidence and inferences in the light most favorable to the defendant, does the record establish that defendant's execution of the Undertaking was supported by either cause or consideration, or by both, and that it was not the result of a mistake within the meaning of the law?

2. Are the jury's verdicts for the defendant against the clear weight of the evidence, and did the Court abuse its discretion by denying plaintiff's motion for a new trial after finding that the weight of the evidence is in favor of plaintiff's contentions?

ARGUMENT

I. The Trial Court Erred in Not Granting Plaintiff's Motion for a Directed Verdict, and in Denying Plaintiff's Subsequent Motion to Set Aside the Verdicts and Judgment for Defendant and Enter a Verdict and Judgment in Plaintiff's Favor for \$231,142.77.

A. Defendant's execution of the Undertaking was supported by cause, or by consideration, or both.

1. *The Applicable Philippines Law.*

The Civil Code of the Philippines (Ex. 66), referred to hereinafter as the Civil Code, is based upon the Spanish Civil Law, but, as will appear, its interpretation frequently draws heavily upon American law.

In the Civil Code, Book IV deals with "Obligations and Contracts." Title I of this Book, headed "Obligations," defines "Joint and Solidary Obligations"; Title II, under the heading "Contracts," sets forth the general rules of contract law; and Title XV deals with "Guaranty." These are the portions of the Civil Code with which we are concerned.

In Title II, Article 1318 establishes that the essential requisites of a contract are (1) "consent," (2) "object certain," and "cause of the obligation which is established." Note that consideration is not mentioned.

Articles 1350 through 1355 of this Title deal with

the meaning of "cause." For present purposes it is sufficient to note that in "onerous" contracts, cause for each contracting party is "the prestation or promise of a thing or service by the other;" and in remuneratory contracts, cause is "the service or benefit which is remunerated." (Art. 1350). While "onerous" contracts are not defined in the Code, the phrase presumably means contracts in which a contracting party undertakes contractual burdens, and is applicable to the defendant's Undertaking in this case.

Note also that under Article 1354, even if cause is not stated in the contract, "it is presumed that it exists and is lawful, unless the debtor proves the contrary."

As the above provisions show, the Civil Code does not make consideration essential to a contract's validity. In the trial of this case the parties' expert witnesses testified that either consideration or cause will make a promise binding; but their answers were somewhat confusing. Defendant's witness said that cause "is the same as" consideration, but "is broader than" consideration (Tr. p. 246). Plaintiff's expert said that cause and consideration are "interchangeable," except that consideration is a "direct benefit," which is different from cause, which could mean "consideration received by another." (Tr. p. 271).

The Court resolved this confusion by instructing the jury, we believe correctly, that "either cause or consideration for a promise is sufficient to constitute

a binding agreement" (Tr. p. 329). Continuing, the Court defined cause for the jury as follows:

"Any reason of substance which may induce the execution of an agreement can be the cause of the agreement. Thus, any promise or performance of a thing or service by the other contracting party can be a sufficient cause to make the obligation binding." (Tr. pp. 329-330)

A recent decision of the Philippines Supreme Court supports the above definition. In *General Enterprises, Inc. v. Lianga Bay Logging Co.*, L. 18487, August 31, 1964 (not yet reported), a logging company was sued for breach of an agreement to supply logs to a distributor for export, and contended on appeal that its promise was not supported by cause or consideration. In rejecting this contention the Supreme Court said:

"We also find untenable the claim that the agreement has no cause or consideration considering that the same imposes reciprocal obligations. A perusal of the agreement would show that appellant designated appellee as its distributor to export logs to Korea and Europe at the best market price obtainable on condition that it would pay appellee a commission of 13% of the gross value of the logs. *The cause of a contract is the essential reason which moves the contracting parties to enter into it* (8 Manresa, 5th edition, p. 450). *In other words, the cause is the immediate, direct and proximate reason which justifies the creation of an obligation thru the will of the contracting parties* (3 Castan, 4th edition, p. 347). Such being the case, it is clear that

for appellant the cause of the agreement is the distribution of its logs in the areas agreed upon which appellee undertook to accomplish, whereas for appellee the cause is its commitment to sell or export the logs for onerous consideration." (*Italics added.*)

Accordingly, we contend that under Philippines law a contract is supported by cause if there was a "direct and proximate reason which justifies the creation of an obligation thru the will of the contracting parties."

The significance of this is that under this concept of cause the technicalities of consideration are irrelevant. All that is necessary to establish cause is evidence that a reason of substance existed that could have induced the contracting party to make his promise.

Indeed it is arguable that under the civil law any formally executed written agreement is *per se* supported by cause. See Lorenzen, "Cause and Consideration in the Law of Contracts," 28 Yale Law Journal 621 (1919).

In any event, it is clear that Philippines law does not require a promise of guaranty to be supported by consideration, as distinguished from cause, because Article 2048 of the Civil Code expressly provides: "A guaranty is gratuitous, unless there is a stipulation to the contrary."

2. *Putnam's Promise Was Supported by Cause.*

On this and other issues arising under plaintiff's contention that the Court erred in not granting plaintiff's motion for a directed verdict, and in denying its subsequent motion for a judgment notwithstanding the verdict, we recognize that these motions could be granted only if, viewing the evidence and the reasonable inferences therefrom in the light most favorable to defendant Putnam, there is no substantial and legally relevant evidence in his favor. *Brady v. Southern Railroad*, 320 U.S. 476, 64 S. Ct. 232, 88 L. Ed. 239 (1943); *Butte Copper & Zinc Co. v. Amerman*, 157 F.2d 457 (C.C.A. 9, 1946); *Wong v. Swier*, 267 F.2d 749 C.A. 9, 1959); *Case-Swayne Co., Inc. v. Sun-kist Growers, Inc.*, 369 P.2d 449 (C.A. 9, 1966). In order to stay within this standard, we will concern ourselves in this portion of plaintiff's brief only with Putnam's own testimony, and with facts that are either agreed or are wholly undisputed.

It should be noted that for purposes of our discussion of the issues of cause and consideration, we necessarily assume that Putnam's execution of the Undertaking was *not* due to "mistake." The issues of cause and consideration arise only if the Undertaking was otherwise a valid and binding agreement.

In approaching the issue of cause, we may start with the Agreement of June 7, 1963 (Ex. 1), which Putnam admittedly executed (Agreed Fact No. 4, R. p. 10). It will be remembered that under the terms of this Agreement Putnam (along with Fogelstrom) *un-*

conditionally obligated himself to obtain a letter of credit for Big Chrome in the sum of \$300,000, less the 20% down payment to Discal, or a net of \$240,000. Under the Agreement, Putnam and Fogelstrom were obligated to obtain the desired letter of credit, no matter what collateral or other security might be required for its issuance.

Putnam testified that when he executed the Agreement on June 7, 1963, he did not know that Ang had already opened negotiations with the Rizal Bank, and that the Bank was requiring Fogelstrom's and his signatures as guarantors of the proposed Letter of Credit (Tr. pp. 155, 205). Putnam also testified that he executed the Agreement without asking what would be expected of him in connection with his obligation to obtain the letter of credit for Big Chrome, and without objecting to assuming this obligation (Tr. pp. 206, 207). As we will point out later in this brief, this testimony seems incredible. Nevertheless, for present purposes, we perforce assume it to be true.

The fact remains, however, that from the terms of the Agreement itself, Putnam must have known in signing it that Big Chrome was unable to obtain its own financing, and that *some* bank had agreed to issue the proposed letter of credit only if he and Fogelstrom (instead of Big Chrome) were responsible for obtaining it. From this it was surely clear to Putnam that the letter of credit was to be issued in reliance on Fogelstrom's and his financial responsibility; there could have been no other reason for requiring

two foreigners to obtain a letter of credit for a local company.

We contend that Putnam's execution of the Agreement clearly charged him with knowledge of the fact that the bank issuing the letter of credit would rely on *his* financial responsibility, not on Big Chrome's.

Moving ahead to Putnam's execution of the Undertaking on December 13, 1963, it is of course undisputed that from the outset the Rizal Bank had in fact insisted on Putnam's signature as a guarantor, as one of the conditions on which the Letter of Credit was to be issued (Ex. 5). Therefore the Bank was clearly entitled to demand that Putnam sign the Undertaking. And on his part, Putnam knew that it was the Rizal Bank that had issued Big Chrome's Letter of Credit (Tr. p. 155), so he presumably understood that he could not refuse to execute an instrument that would make him liable on the Letter of Credit, along with Big Chrome.

In these circumstances Putnam's contractual obligation to obtain the Letter of Credit for Big Chrome gave him a "direct and proximate reason" for executing the Undertaking, and this clearly was cause under Philippines law.

But of course there was other cause too.

Putnam was a major participant in the Big Chrome venture. He had invested \$48,000 of his own money in the Company, and was obligated by the June 7, 1963 Agreement to contribute additional funds as

needed. He had sold the Company some major items of equipment, for which he had already received \$100,000 from the discounting of Big Chrome's Letter of Credit; and if the mining machinery wasn't made available for delivery to Big Chrome, Putnam might ultimately have to return this payment, at the demand either of Discal itself or of Pacific National Bank, where the Letter of Credit was discounted. (Note that at some time, the date not being clear in this regard, Putnam became a guarantor of this discount.) And finally, the June 7, 1963 Agreement obligated Putnam to devote the next ten years of his life to serving as Big Chrome's field manager, and entitled him to a substantial share of its profits. All of these facts show that on December 13, 1963, Putnam had urgent business reasons for helping Big Chrome to get possession of the shipping documents, which in turn would govern the right to possession of the mining machinery when it reached Manila. As Putnam knew, the entire Big Chrome venture would collapse if Big Chrome could not get prompt possession of the mining machinery.

In these circumstances Putnam's substantial participation and interest in the Big Chrome venture provided him with ample cause for executing the Undertaking.

As the Court below said in its order on plaintiff's Motion for Judgment N.O.V.:

"That the defendant had a substantial interest in the profits of Big Chrome, the principal in the undertaking, there is no doubt. He was contrac-

tually committed to work for that company for ten years as a field manager. He knew that the principal needed \$300,000.00 in order to purchase the necessary equipment, and that he and Fogelstrom were under a duty to secure this financing for the company. Certainly, his investment of \$48,000.00 in Big Chrome was substantial. A part of this was to be used to obtain financial backing. Big Chrome's equipment purchases included a substantial sum of his own equipment, plus other equipment which he purchased for the project. Without going into further detail, I express the opinion that there was valid cause for defendant's execution of the undertaking." (R. pp. 82-3).

3. *Putnam's Promise Was Also Supported by Consideration.*

As stated previously, plaintiff contends that under Philippine law a promise supported by cause is binding, whether or not consideration is also shown. However, we deem it appropriate to point out that in this case Putnam's promise of guaranty was supported by consideration as well as by cause.

On this issue we again urge that Putnam's execution of the June 7, 1963 Agreement, even on the bare facts of the Agreement itself and Putnam's own testimony, must be construed as obligating him to do whatever proved to be necessary to obtain the desired letter of credit for Big Chrome, specifically including becoming liable on the letter of credit along with Big Chrome. On this basis the consideration supporting Putnam's promises in the Agreement also supported his promise of guaranty in the Undertaking.

Apart from this, however, consideration is also established by Putnam's own version of the circumstances in which he executed the Undertaking.

It may first be noted that Chiong testified that early in December 1963 he told Ang that Putnam and Fogelstrom would have to sign their personal guaranty before the Bank would release the shipping documents to Big Chrome (Tr. p. 66).

Putnam agreed with this. According to his testimony, he went to the Bank on December 13, 1963 because "there were some papers out there that would have to be signed in order to allow Big Chrome to get the shipping documents so they can get their Customs clearance and their tax exemption." (Tr. p. 163). The Undertaking looked to Putnam like it would give Big Chrome "the right to have these documents to take from the bank and do what they had to do with them." (Tr. pp. 165, 217). And Putnam understood that "maybe they needed my signature to release these documents to Big Chrome." (Tr. p. 165).

Thus Putnam's version of this transaction is that he executed the Undertaking in return for the Bank's promise to release the shipping documents to Big Chrome. This promise was valid consideration for Putnam's promise of guarantee. The Bank's promise was subject to the further condition that Big Chrome execute a trust receipt, as an interim security instrument giving the Bank a lien on the machinery and equipment pending execution of a chattel mortgage. But this does not make the Bank's promise any less

valid or adequate as consideration for Putnam's execution of the Undertaking.

Finally, we also contend that under Philippines law the Rizal Bank's issuance of the Letter of Credit on August 8, 1963 was valid consideration for Putnam's subsequent execution of the Undertaking on December 13, 1963. In *Bank of the Philippines v. Foerster, Administrator*, 49 Phil. 843 (1923), a corporate officer executed a guaranty of his corporation's liability on a pre-existing loan. While the issue of cause or consideration was not discussed, the Philippines Supreme Court held that because the guaranty clearly was intended to apply to the Bank's prior advances, it was enforceable as such. The reasoning of this case is fully applicable here, because while Putnam was not a corporate officer of Big Chrome, he was an investor in it, a principal participant in planning its business operations; and the Undertaking was clearly intended to apply to the previously issued Letter of Credit.

As noted previously, the trial court held that the jury's special finding that Putnam's execution of the Undertaking was not supported by consideration could not stand (R. p. 83).

B. Defendant is bound by the Undertaking, even if he signed it without knowing its contents, because of his own negligence.

1. The Applicable Philippines Law.

Article 1318 of the Civil Code (in Chapter 2 of Title II of Book IV of the Code) as previously men-

tioned, provides that one of the essential requisites of a contract is consent; and Article 1319 provides that consent is manifested "by the meeting of the offer and acceptance upon the thing and the cause which are to constitute the contract."

The subject of mistake as vitiating consent is dealt with in Articles 1330, 1331 and 1333. The pertinent provisions of these Articles are as follows:

"Article 1330. A contract where consent is given through mistake . . . is voidable.

"Article 1331. In order that mistake may invalidate consent, it should refer to the substance of the thing which is the object of the contract, or to those conditions which have principally moved one or both parties to enter into the contract . . .

"Article 1333. There is no mistake if the party alleging it knew the doubt, contingency or risk affecting the object of the contract."

Under these provisions, defendant Putnam contended that his signature on the Undertaking was obtained through a mistake "going to the very substance of the subject matter of the Undertaking." (R. p. 23).

At the trial, the parties' respective expert witnesses expressed opposing opinions as to the meaning and effect of the above provisions. Defendant's expert said that if a contracting party is offered an opportunity to read an agreement, but elects not to read it, and instead to accept its provisions on the assurance of a

business colleague that it is an appropriate instrument for him to sign, and he therefore signs without knowing the provisions of the agreement, he is not bound by it, because "the essential element of a binding contract is consent," which is absent on the foregoing facts (Tr. pp. 248, 261). Plaintiff's expert testified that there would be no mistake in these circumstances, and the party would be bound (Tr. pp. 274, 288). Neither expert cited any authority for his opinion.

2. *Putnam's deliberate recklessness bars his defense based on mistake.*

On this issue our principal concern is with what was said and done at the Rizal Bank on December 13, 1963, when Putnam and Fogelstrom signed the Undertaking. And on the motion under review here, we of course put to one side the testimony of Chiong and Pineda about these events. It should be remembered, however, that both Chiong (Tr. pp. 67, 87-8) and Pineda (Tr. pp. 98-9), testified that they told Putnam that the Undertaking would make him liable as a guarantor, and Pineda said that he handed the Undertaking to Putnam and Fogelstrom "so you may read it yourself," and that Putnam in fact read it.

We have previously set forth Putnam's version of the events of December 13, 1963 in detail (*supra* p. 22ff.), so we will review it only briefly here.

Putnam said that he accompanied Ang and Fogelstrom to the Rizal Bank to sign some papers that had to be signed "in order to allow Big Chrome to get

the shipping documents.” (Tr. p. 163). At the Bank, he, Ang and Fogelstrom went to Chiong’s office. Chiong was busy, but found the papers he wanted (i.e. the Undertaking) on his desk, “and asked us to look at them and sign them.” (Tr. p. 164). Note that Putnam admits that Chiong expressly asked him to examine the Undertaking before signing it.

Fogelstrom signed the Undertaking first, then handed it to Putnam. Putnam’s testimony about what happened next was as follows:

“I glanced at the top, and it said ‘Undertaking.’ I never read the whole thing through, because they told me that this was a necessary thing, and everybody else signed, so I figured if they had the nerve to, why, I also did.” (Tr. pp. 164-5).

Putnam admitted that it was Fogelstrom, not the Bank’s representative, who told him that it was all right to sign the Undertaking without reading it (Tr. p. 165), and he also admitted that “I probably could have taken time (to read it) *if I had wanted to.*” (Tr. p. 217).

The foregoing is the evidence which Putnam claims establishes that he signed the Undertaking by mistake, thinking it to be a customs or tax instrument, and without knowing that it purported to make him liable as a guarantor of Big Chrome.

On this issue the Court instructed the jury as follows:

“If you find from a preponderance of the evi-

dence in the case that the defendant, *through no negligence or fault of his own*, did not know or appreciate that the undertaking required him to be a guarantor or surety for Big Chrome, and that the defendant did not intend to take on this responsibility, but only believed that he was signing papers which would permit Big Chrome to obtain a Customs clearance and tax exemption for the mining machinery and equipment, *and that he acted as an ordinary, prudent person under the then existing circumstances and conditions*, then your verdict must be against the plaintiff and in favor of the defendant. The burden of proof is on the defendant on this issue." (Tr. p. 342) (Italics added.)

Thus the Court correctly told the jury that it could not find that Putnam's alleged mistake relieved him from liability under the Undertaking if the mistake was due to negligence or fault of his own, or if he did not act with ordinary prudence.

We do not quarrel with the foregoing instruction, if the mistake issue was to be submitted to the jury at all. But we contend that, on Putnam's own testimony, his alleged mistake was due to his own negligence or fault *as a matter of law*, and that for this reason the Court erred in denying plaintiff's motion to withdraw this issue from the jury's consideration, and its subsequent motion for a judgment N.O.V.

This is not a case in which an inexperienced and unwary layman overlooked an obscure provision hidden in small print in a complicated contract, or in

which a failure to read before executing an agreement resulted from pressures or misrepresentation by the other contracting party.

In this case Putnam, a businessman with varied experience, was in the banking offices of the Bank that he knew had issued Big Chrome's Letter of Credit, which he and Fogelstrom had been obligated to obtain for Big Chrome. And the Bank—not Ang, or Fogelstrom—was asking him and Fogelstrom to join in executing an instrument.

According to Putnam, Chiong handed the instrument to them and asked to them to look at it. Fogelstrom presumably did so, and after signing it, handed it to Putnam. Putnam had it in his own hand. If he had previously thought that he was to sign a document having to do with customs or tax matters, he now saw that, instead, it was headed "Undertaking," and its first sentence, which Putnam presumably read (Tr. p. 315), said in plain terms that "the undersigned agrees to pay in joint and several capacity" to the Rizal Bank, upon demand, "all of the said obligations" of Big Chrome when due. Surely this would have warned a prudent man that he should read on, before signing the instrument on the assumption that it dealt with customs or tax matters.

An examination of the Undertaking (Ex. 10) will show that it is a short instrument, its substantive provisions occupying only a single typed page, with double-space typing and wide margins. Putnam could have finished reading it in another minute or two. It

does *not* look like a customs or tax document. It looks like exactly what it is.

Apparently Fogelstrom became impatient and told Putnam that the Undertaking "was a necessary thing," by which Fogelstrom probably meant that Putnam was obligated to sign it in any event, and so need not bother to read it. Putnam thereupon signed the Undertaking, according to his testimony, without ever discovering that it was not a customs or tax document.

The plain fact is that Putnam *deliberately* chose not to read the Undertaking before signing. He testified that he had time to read it if he had wanted to. *But he did not want to.* He elected to sign it without reading it because he "had the nerve" to risk the consequences—specifically, he had the nerve to risk any liability that the Undertaking might impose, so long as this would make the shipping documents available to Big Chrome. Thus *Putnam voluntarily took the risk of an unknown liability, which turned out to be that of a guarantor of Big Chrome.* This was such deliberate recklessness on his part as to constitute negligence as a matter of law.

Under Philippines law, as under American law, one who deliberately chooses to sign a contractual instrument without reading it, there being an opportunity to do so, and no deception or fraud by the other contracting party, and no obscurity in the instrument, is liable in accordance with the contract's terms.

With respect to Philippines law, we may begin by

noting that the Philippines Supreme Court has established the rule that a unilateral mistake by one contracting party, to which the other party has not contributed, will not suffice to avoid the contract.

In *Gonzales Mondragon v. Santos*, 87 Phil. 471 (1950), a mother and her adult children, each of whom owned separate parcels making up a large tract of land, joined in executing a contract for the sale of the entire tract. The mother believed that her parcel contained 1,023 hectares. The contract did not mention this, but specified that she was to be paid 460,000 pesos, which is apparently a rounding out of 1,023 hectares at 450 pesos per hectare. Shortly after the sale a new survey established that the mother's parcel contained 1,091.24 hectares, instead of 1,023 hectares. Thereupon the mother sued to rescind, or for payment to her for 1,091.24 hectares at 450 pesos each, claiming that she signed the deed without reading it, in the mistaken belief that it provided that she would be paid 450 pesos per hectare for her parcel. After an adverse decision in the trial court, the mother appealed. The Supreme Court of the Philippines affirmed, and laid down the following rule:

“Decisions of this court and of American courts abound in favor of the salutary doctrine that contracts solemnly and deliberately entered into may not be overturned by inconclusive proof *or by reason of mistakes of one of the parties to which the other in no way has contributed.*” 87 Phil. at 478. (Italics added.)

In a later decision the *Gonzales Mondragon* case

was cited as establishing that contracts deliberately entered into may not be overturned "by reason of mistake of one of the parties to which the other has in no way contributed." See *Pilar Gil Vda. de Murciano v. The Auditor General*, 103 Phil. 907, 912 (1958).

In *Facundo v. Lim*, 85 Phil. 641 (1950), a vendor claimed he signed a contract for the sale of his land without reading it, and so did not know that it provided that he was to be paid in "lawful circulating currency," i.e., Japanese military notes, instead of in true Philippine currency. On appeal, the Philippines Supreme Court affirmed the trial court's rejection of this claim, saying:

"Not much weight can be accorded to appellant's declaration that he signed the deed without reading the same. Appellant was neither illiterate nor ignorant. *It is, therefore, not reasonable to suppose that he would sign a contract involving a large sum without first being certain that it expressed his true will.* His allegation that he was not able to read the contract because he did not have his glasses with him . . . is but a flimsy excuse for this belated effort on his part to get out of the deal. We see nothing that would have prevented him from sending for his glasses before closing the transaction. . . ." 85 Phil. at 644. (Italics added.)

The earlier case of *Javier v. Javier, Administrator*, 7 Phil. 261 (1907) is to the same effect. In this case Segundo Javier claimed that in 1885, with his father's consent, he built a house at his own expense on a lot owned by his father. In 1887 his brother Fe-

lix, having borrowed some money, signed several receipts which referred to the lot on which this house was built as "the lot upon which the house of strong materials, No. 520 Calle Real or Cabanas, the exclusive property of my brother, Segundo Javier is built." Thereafter the father died. The father's executor included the house in the inventory, and Segundo Javier petitioned to have it deleted therefrom. At the trial Felix Javier admitted the authenticity of the above receipts, but testified that he signed them without knowing their contents. The trial court denied the petition, and Segundo Javier appealed. The Supreme Court of the Philippines reversed, and said:

"An attempt was made by Felix Javier to overcome the probatory force of the documents signed by him, he alleging that he signed the same without first informing himself as to their contents, except that part thereof relating to the sums of money mentioned in the same. We cannot give credit to this explanation. *The natural presumption is that one does not sign a document without first informing himself of its contents,* and that presumption acquires greater force where not one only, but several documents, executed at different times and at different places, as is here the case, were signed. There is nothing in the record that can in any way overcome this presumption." 7 Phil. at 266-7. (Italics added.)

We submit that these cases establish that under Philippines law a contracting party cannot escape liability under a contract solemnly entered into on the ground that he deliberately elected not to read it be-

fore signing it, and so was mistaken as to its contents, when the other contracting party has in no way contributed to the mistake.

It will be noted that in the language quoted above from the *Gonzales Mondragon* case, *supra*, the Philippines Supreme Court expressly relied in part on decisions of the American courts as a basis for the above-stated doctrine. The American decisions clearly are in accord, as shown by the following authorities:

In *Upton v. Tribilock*, 91 U.S. 45, 23 L. Ed. 203 (1875), the Supreme Court said:

“That the defendant did not read the charter and by-laws, if such were the fact, was his own fault. It will not do for a man to enter into a contract and, when called upon to respond to its obligations, to say that he did not read it when he signed it, or did not know what it contained. If this were permitted, contracts would not be worth the paper on which they were written. But such is not the law. A contractor must stand by the words of his contract; and, if he will not read what he signs, he alone is responsible for his omission. (Citing.)” 91 U.S. at 50, 23 L. Ed. at 205.

In *Danciger Oil & Refining Co. v. Ball*, 54 F.2d 908 (C.C.A. 5, 1932), the defendant claimed that he signed a contract through a mistake induced by fraud. It appeared, however, that the defendant could have read the entire contract in three or four minutes, and he admitted that the contract was handed to him to read and that no one prevented him from

reading it. The Court of Appeals for the Fifth Circuit found that there was no proof that fraud or misrepresentation kept defendant from reading the contract before signing it, and held that proof of fraud or misrepresentation "is necessary to excuse Ball's negligence and prevent his signing from being taken conclusively as an adoption by him of the contract as written." 54 F.2d at 910.

In *Holly Stores v. Judie*, 179 F.2d 730 (C.A. 7, 1950), a corporation for whom experienced businessmen were acting claimed that it executed a lease without knowing that it contained a provision to which it now objects. The lease was written in plain and unambiguous language, so that a mere reading of it would have been sufficient for discovery of the objectionable provision. In these circumstances the Court of Appeals for the Seventh Circuit said that the plaintiff could as easily have discovered the alleged error before execution of the lease as afterward. The Court continued:

"Plaintiff thus finds itself empaneled on one prong or the other of a two-horned dilemma — either it did not read the lease, or if it did so no heed was given to its plain and unambiguous terms—and its position on one horn is no better than on the other. *That its failure to know and understand the provisions of the lease which it solemnly executed was the result of its own inexcusable negligence is beyond the pale of reasonable argument.*" (179 F.2d at 734, emphasis added.)

In *Oregon-Pacific Forest Products Corporation v. Welsh Panel Company*, 248 F. Supp. 903 (D. Ore. 1965), Judge Kilkenney said that under the laws of both Oregon and Washington, "It is no defense that a party, seeking to avoid the contract, did not read it," the only exceptions being parol evidence to show the circumstances under which the agreement was made, to explain an ambiguity, or to establish illegality or fraud. 248 F. Supp. at 908.

In *Shell Oil Company v. Boyer*, 234 Or. 270, 381 P.2d 494 (1963), Shell sought specific performance of a purchase option in a service station lease. The defendants testified that when they signed the lease they noticed the paragraph entitled "Option to Purchase" and another paragraph entitled "Purchase Refusal," and asked Shell's agent, subsequently deceased, the meaning of these paragraphs. According to the defendants, the agent's answer explained the second but not the first of these options, and assured them that Shell was not interested in buying service stations. The Oregon Supreme Court found that the two options were clear and understandable, though possibly ambiguous when read together. The Supreme Court said:

"If the testimony of the lessors is believed, they relied upon the agent's interpretation of the legal effect of the two clauses rather than upon their own reading. Ordinarily, the failure to read an instrument, when there is ample opportunity to do so, is no defense to its enforcement. See *Long v. Smith Hotel Co. et al*, 115 Or. 306, 237 P. 671 (1925)." 234 Or. at 276, 381 P.2d at 497.

Also see American Law Institute, Restatement of Contracts, Section 70; and Williston on Contracts, Section 90A.

Before closing on this subject, we call attention to Article 1333 (quoted above) of the Civil Code, which provides that there is no mistake "if the party alleging it knew the doubt, contingency or risk affecting the object of the contract." We have been unable to find any Philippines cases construing this provision. However we suggest that the "doubt, contingency or risk" affecting the object of the Undertaking was whether the Rizal Bank would release the shipping documents to Big Chrome. Putnam admittedly knew this, and indeed his own testimony was that he signed the Undertaking in order to enable Big Chrome to obtain these documents "and do what they had to do with them." (Tr. p. 165). Therefore Article 1333 by its terms bars Putnam's claim of mistake.

On the basis of all of the foregoing authorities, we submit that even viewing the evidence and the inferences therefrom in the light most favorable to Putnam, it is clear that Putnam's deliberate election not to read the Undertaking before signing it constituted negligence as a matter of law, so that he cannot avoid liability under the Undertaking on the ground of mistake.

C. The amount of the judgment to be entered.

It has long been established that a Federal court can grant a directed verdict, or a judgment notwith-

standing the verdict, in favor of a plaintiff as well as of a defendant. *Delaware, Lackawanna & Western Railroad Company v. Converse*, 139 U.S. 469, 11 S. Ct. 569, 35 L. Ed. 213 (1891). And on a plaintiff's motion for judgment N.O.V., where the amount of the judgment to be entered can be computed from the undisputed testimony, the Court can make the computation. *United States v. Grannis*, 172 F.2d 507 (C.A. 4, 1949), cert denied 337 U.S. 918, 69 S. Ct. 1160, 93 L. Ed. 1727; *Baltimore Gas & Electric Co. v. United States Fidelity & Guaranty Co.*, 166 F. Supp. 703 (D.Md. 1958).

In this case, however, the amount of the principal is fixed by Agreed Fact No. 19 (R. p. 13), and the parties stipulated in open court that on plaintiff's motion for a judgment notwithstanding the verdict, either the District Court or the Court of Appeals may fix the amount of interest to which the plaintiff is entitled (Tr. pp. 364-5).

As previously stated here, plaintiff's motion for a judgment N.O.V. in the sum of \$231,142.77 is based on a computation (set forth in the motion, R. p. 45) from which every item challenged by the defendant has been eliminated. A judgment in this amount would be fully supported by the undisputed evidence, and indeed there would be no basis in the record for a judgment in a lesser amount.

D. Conclusion.

We respectfully contend that the foregoing argument has shown that the Court should have held as

a matter of law (1) that there was cause, and also consideration, for defendant's execution of the Undertaking; (2) that defendant is not entitled to avoid liability under the Undertaking on the ground of mistake; and (3) that plaintiff's recovery should be not less than the sum of \$231,142.77; and that therefore the Court erred in denying plaintiff's motion for judgment notwithstanding the verdicts for defendant, in the said sum of \$231,142.77.

II. The Verdicts are Against the Clear Weight of the Evidence, and the Trial Court Abused Its Discretion in Denying Plaintiff's Motion for a New Trial.

A. The trial court's denial of plaintiff's motion for a new trial was an abuse of discretion, reviewable in this court.

Plaintiff's alternative motion for a new trial, which is reached for consideration only if its motion for a judgment notwithstanding the verdicts for defendant is denied, was on the ground that the verdicts are against the clear weight of the evidence and result in a serious miscarriage of justice (R. p. 46). In ruling on this motion the Court said:

"I personally feel that the weight of the evidence is in favor of plaintiff's contentions."

The Court nevertheless denied the motion for a new trial, solely on the ground that granting a new trial "would only postpone the ultimate conclusions of the Court of Appeals" on the disputed questions of law involved in the case (R. p. 86; *infra*, App. p. 12).

The trial court's determination in its discretion

that the weight of the evidence was in plaintiff's favor provided a lawful and proper basis for granting plaintiff's motion for a new trial. *Montgomery Ward & Co. v. Duncan*, 311 U.S. 243, 61 S. Ct. 189, 85 L. Ed. 147 (1940); *Moist Cold Refrigerator Co. v. Lou Johnson Co.*, 249 F.2d 246 (C.A. 9, 1957), cert. den., 356 U.S. 968, 78 S. Ct. 1008, 2 L. Ed. 2d 1074.

After the Court made this finding, the fact that a new trial would delay appellate review of the disputed legal questions was not a valid ground for its denial of plaintiff's motion. Granting a new trial will *always* result in delaying appellate review of disputed legal questions. If this were a valid reason for denying an otherwise justified new trial, a new trial could *never* be granted when there are disputed legal questions. The denial of plaintiff's motion on this ground was a plain abuse of the court's discretion.

It is well established that when a district court abuses its discretion in denying a motion for new trial, the denial is reviewable, and the Court of Appeals may reverse and remand with directions to grant a new trial. This is shown by the following cases:

In *United States v. Simmons*, 346 F.2d 213 (C.A. 5, 1965), a taxpayer's suit for an estate tax refund, the trial court had denied motions for a judgment N.O.V. and for a new trial. The Court of Appeals affirmed the denial of a judgment N.O.V., but held:

"We reverse the judgment and remand the case for a new trial, because there was no ra-

tional basis for the jury's finding." 346 F.2d at 215.

In *Georgia Pacific Corporation v. United States*, 264 F.2d 161 (C.A. 5, 1959), the only issue on appeal was the appellant's contention that the trial court had erred in denying its motion for a new trial, based on a complete lack of evidence to support the verdict. The Court of Appeals held that on the undisputed facts the only permissible verdict was for the appellant, and said:

"The refusal of the court to grant a new trial was a clear abuse of discretion. The judgment is, therefore, reversed and the cause is remanded with directions to grant a new trial." 264 F.2d at 166.

In *Charles v. Norfolk & Western Railway Company*, 188 F.2d 691 (C.A. 7, 1951), cert. den., 342 U.S. 831, 72 S. Ct. 55, 96 L. Ed. 628 (1951), the trial judge expressed his disagreement with the verdict, but denied a motion for a new trial. The Court of Appeals reversed the judgment with directions to grant a new trial.

Also see *Sulzbacher v. Continental Casualty Company*, 88 F.2d 122 (C.C.A. 8, 1937) (district court denied motion for new trial without considering its merits; judgment reversed and remanded with directions to grant a new trial).

And cf *Magee v. General Motors Inc.*, 213 F.2d 899 (C.A. 3, 1954), where the district court told the jury that in his opinion the verdict was against the

clear weight of the evidence, but thereafter denied a motion for a new trial. Holding that this was "an abdication of the judge's functions," the Court of Appeals reversed and remanded with directions to reconsider the motion for a new trial. In accord: *Paine v. St. Paul Union Stock Yards Co.*, 35 F.2d 624 (C.C.A. 8, 1929).

On the basis of these authorities, it is clear that in the instant case the trial court abused its discretion in denying plaintiff's motion for a new trial, and this Court may review the ruling on this motion, and may itself reverse and remand with instructions to grant plaintiff a new trial.

B. The verdicts for defendant are against the clear weight of the evidence.

On this issue we again turn first to the circumstances in which the Agreement of June 7, 1963 was executed.

As previously related in our statement of the facts, Ang and Robles first talked to Putnam and Fogelstrom about Big Chrome early in April, 1963; Ang opened negotiations with the Rizal Bank in the middle of April; Putnam visited the Big Chrome mine on April 27 and 28; and Ang returned to the Rizal Bank at the end of April, being then told by Chiong that the Bank would require a 25% marginal deposit and individual guarantees by Putnam and Fogelstrom as conditions for the issuance of the desired letter of credit. Putnam left Manila on May 5, to return to the United States.

Putnam testified that during this period, he, Ang, Robles and Fogelstrom "were discussing this thing daily, because usually we all had lunch together." (Tr. p. 194).

We submit that during these luncheon conversations Ang must surely have reported to the others about his negotiations with the Rizal Bank. It is inconceivable that Ang would have concealed his negotiations from his own "boss"—Ang was employed in Discal's Manila office, and Fogelstrom was a vice president of Discal.

It is likewise inconceivable that Ang and Fogelstrom would have failed to tell Putnam about the Rizal Bank's requirements. Indeed they *had* to make such a disclosure, because they *had* to know whether Putnam would agree to sign as a guarantor for Big Chrome.

The significance of this is that, contrary to his own testimony (Tr. pp. 154, 206), *Putnam almost certainly knew at this time about Ang's negotiations with the Rizal Bank, and about the Bank's requirement that he (Putnam) sign as a guarantor of Big Chrome.*

Putnam returned to Manila on May 13, and went to work on planning the equipment and operating methods that would be used by Big Chrome. Within the next two or three weeks he submitted his proposal to Ang and Robles, they approved it, he and Fogelstrom made their definite decision to join the Big Chrome venture, and the June 7, 1963 Agreement

was negotiated and drafted. As drafted, the Agreement included the provision obligating Putnam, jointly with Fogelstrom, to obtain a \$300,000 letter of credit for Big Chrome, with a 20% down payment to Discal, liquidation of the balance in semiannual installments over a three-year period, and a 25% marginal deposit, *all as Ang had previously agreed with the Rizal Bank.*

Putnam testified that during this period the proposed Agreement "was discussed with me almost every evening, at least, regarding what they were accomplishing, and the methods that they may go about—different things within this contract before it was signed." (Tr. p. 206).

Nevertheless Putnam testified that at this time he had never heard of the Rizal Bank, and did not know that Big Chrome was to get the letter of credit from it, and that the Bank would require his signature as a guarantor (Tr. pp. 154, 161, 162). We submit that this testimony is incredible.

To begin with, we have shown above that Ang and Fogelstrom almost certainly had told Putnam during the luncheon discussion in late April or early May about their negotiations with the Rizal Bank. But if they had not done so before, they surely would have told Putnam about these negotiations in discussing with him his proposed obligation to join in getting Big Chrome's letter of credit. *If Ang and Fogelstrom did not then tell Putnam that he was going to have to sign as a guarantor of Big Chrome, they deceived*

him, and obtained his execution of the Agreement by means of this deceit. But Putnam has never claimed that Ang and Fogelstrom deceived him or tricked him into becoming a guarantor of Big Chrome.

And on Putnam's part, it is inconceivable that he would have signed the Agreement blindly, obligating himself unconditionally to obtain the letter of credit for Big Chrome, without finding out what would be expected of him in connection with this obligation.

For these reasons we contend that the clear weight of the evidence establishes that Putnam signed the June 7, 1963 Agreement with full knowledge of the negotiations with the Rizal Bank, and of the conditions on which a letter of credit could be obtained for Big Chrome, and knowing and intending that by signing the Agreement he was obligating himself to become a guarantor for Big Chrome.

Moving ahead now to Putnam's execution of the Undertaking on December 13, 1963, Putnam's testimony here, too, is incredible.

Note that the testimony of Chiong and Pineda shows that they presented the Undertaking to Putnam and Fogelstrom in an orderly, business-like manner. Their testimony is inherently reasonable and believable.

Putnam's testimony that Ang and Fogelstrom led him to think that the instrument he was signing had something to do with Customs or with a tax exemption (Tr. p. 163) is equivalent to charging, again,

that Ang and Fogelstrom deceived him; yet as stated above, Putnam has never made such a claim.

Putnam's claim that the Undertaking looked to him like a customs or tax document is utter nonsense. The Undertaking does not even remotely look like such a document. As we have said previously, it looks like what it in fact is, an instrument of guaranty.

Moreover, it is incredible that Putnam would go to the Bank that he knew had issued Big Chrome's Letter of Credit, which he had obligated himself to get for Big Chrome, and that he would sign an instrument which he saw was entitled "Undertaking," and the first portion of which he admittedly read, without knowing what it was he was signing. The only reasonable explanation for Putnam's readiness and willingness to sign the Undertaking is that he had known at least since the execution of the June 7, 1963 Agreement that he was going to have to sign as a guarantor of Big Chrome's liability under the Letter of Credit, and signing the Undertaking was nothing more than the carrying out of what he was already obligated to do.

Putnam strains credulity too far when he claims both that he executed the June 7, 1963 Agreement without understanding its obvious import, and that he executed the Undertaking believing it to be merely a customs or tax instrument.

We submit that the clear weight of the evidence is that on December 13, 1963 Putnam knew that he was contractually obligated to sign as a guarantor of

Big Chrome's liability under the Letter of Intent, and that he signed the Undertaking intending to become such a guarantor.

Putnam's subsequent conduct corroborates this.

According to his testimony, Putnam first learned that he was liable as a guarantor of the Letter of Credit after his rupture with Big Chrome. This was in March 1964 (Tr. pp. 172, 173). Putnam said he was "surprised" to learn that he was a guarantor but was assured by Fogelstrom that Ang was capable of taking care of any obligation (Tr. p. 219). Bearing in mind that Putnam had just walked out of the Big Chrome venture in anger because he thought it was doomed to failure, his reaction to learning that he had a contingent liability of \$269,435.70 as a guarantor for Big Chrome seems extraordinarily mild.

Putnam went to the Rizal Bank just a few weeks later, and talked to Choing about the status of the Big Chrome account (Tr. p. 174). At this meeting Putnam did not suggest any doubt or question about his liability as a guarantor, or any surprise or objection.

Putnam returned to the Bank on other occasions in 1964 and 1965, and during 1966 he talked with Attorney Meer, without ever questioning his liability as a guarantor. On the contrary, he acknowledged his liability, and sought (and received) the Bank's cooperation in trying to minimize it by getting new financing for the operation of the Big Chrome mine. On September 19, 1966, after Fogelstrom had suggested that he and Putnam needn't be concerned about their guar-

anties (Ex. 20), Putnam scolded Fogelstrom in an answering letter, telling him that while the credit was made out to Big Chrome, Ang and his father (since deceased) "and you and I are the guarantors," and

"I will not stand for anyone to try to get out of his obligation or in any way cause the Bank any trouble because they went along with us in good faith and have been very lenient." (Ex. 21).

It is incredible that Putnam would not have indicated some question, and probably considerable resentment, at some time during this period, if he in fact believed that he had signed the Undertaking through a mistake, believing it to be a customs or tax exemption instrument. His ready and complete acquiescence in his liability as a guarantor contradicts his belated* claim of mistake.

We repeat, therefore, that Putnam did *not* sign the Undertaking through a mistake. He knew and intended that he was obligating himself as a guarantor of Big Chrome.

The clear weight of the evidence also establishes that Putnam's promise of guaranty was supported by cause and consideration. In support of this it is enough to point again to Putnam's obligations under the June 7, 1963 Agreement, and to the dire consequences that would have resulted for the Big Chrome venture and for Putnam himself if he had refused to sign the Un-

* Note that defendant did not claim "mistake" as a defense in his answer in this case (R. p. 3).

dertaking. In the context of this transaction, the jury's findings that Putnam was a gratuitous guarantor, without a reason of substance (within the trial court's instruction) for signing the Undertaking, were without a rational basis in the evidence.

C. Conclusion.

We respectfully contend that the verdicts and judgment for the defendant in this case are against the clear weight of the evidence. Further, they constitute a serious miscarriage of justice. The Rizal Bank necessarily relied from the outset on the financial responsibility of the guarantors of the Letter of Credit, since Big Chrome had no assets of its own, and the mining machinery was not even in existence when the Bank's commitment was made. Furthermore, Putnam himself has received \$100,000 from the proceeds of the Letter of Credit, having been paid for his equipment with the Rizal Bank's money. In these circumstances it is especially unjust for him to avoid his clear liability under the Undertaking.

III. General Conclusion and Prayer

The evidence in this record and the reasonable inferences therefrom, even when viewed in the light most favorable to defendant Putnam, establish as a matter of law that there was cause for Putnam's execution of the Undertaking, and, while cause alone is sufficient, that there was also consideration therefor; and the said evidence and inferences, when so viewed, also establish as a matter of law that if Putnam's ex-

ecution of the Undertaking was through a mistake, the mistake was due solely to such negligence on his part as precludes his avoidance of liability on this ground. Therefore the Court erred in submitting these issues to the jury, and thereafter in denying plaintiff's motion for a judgment notwithstanding the verdict. The undisputed evidence establishes that the judgment for plaintiff should be in the sum of \$231,142.77.

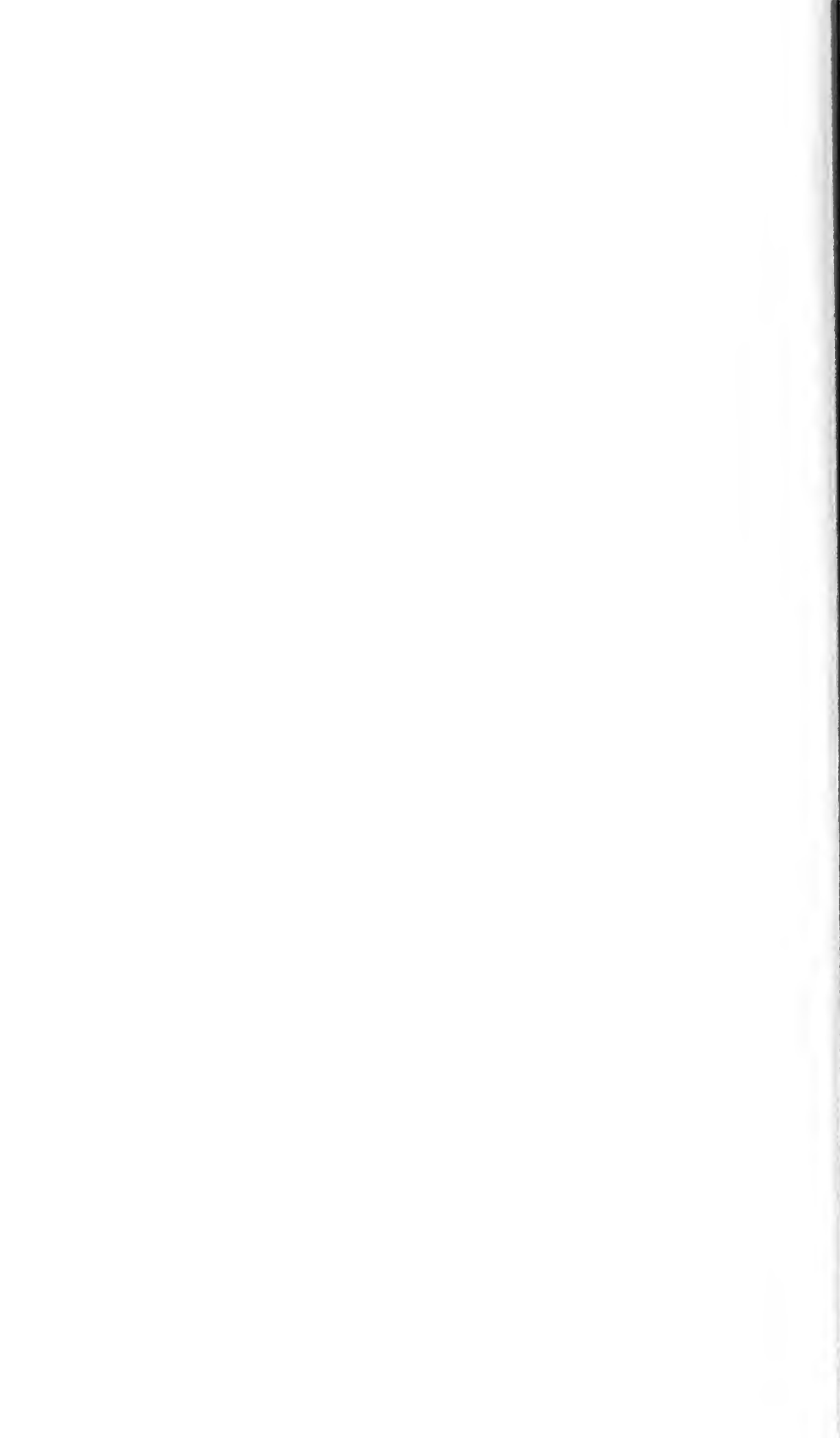
Further, a review of all of the evidence and the inferences therefrom establishes that the verdicts for defendant are against the clear weight of the evidence and result in a serious miscarriage of justice; and the Court below, having reached this conclusion, abused its discretion in denying plaintiff's motion for a new trial.

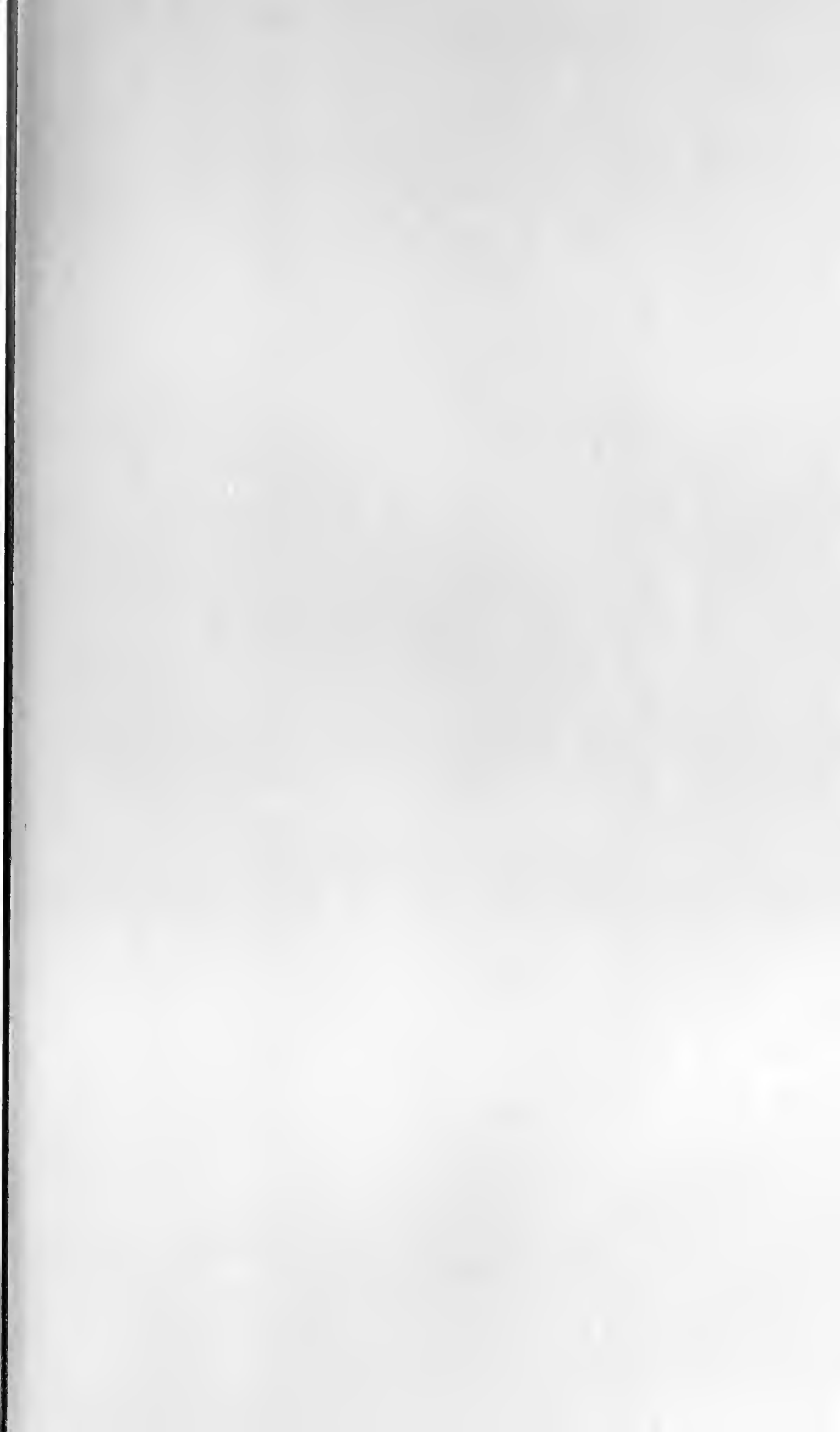
Accordingly, plaintiff prays that the judgment below be reversed and the case remanded with directions to set aside the verdicts and judgment for defendant and enter a judgment for plaintiff in the sum of \$231,142.72.

In the alternative, if the foregoing prayer is denied, plaintiff prays that the judgment below be reversed and the case remanded with directions to set aside the verdicts and judgment for defendant and grant plaintiff a new trial.

Respectfully submitted,

ALLAN HART
LINDSAY, NAHSTOLL, HART, DAFOE
& KRAUSE
Attorneys for Plaintiff-Appellant







APPENDIX A

UNDERTAKING

For and in consideration of any loans, advances, letters of credit, trust receipts, drafts and other credit facilities, up to \$300,039.78 (US dollars) that have been granted and/or may be granted by the RIZAL COMMERCIAL BANKING CORPORATION to BIG CHROME EXPLORATION hereafter known as the principal, the undersigned agrees to pay in joint and several capacity to the said RIZAL COMMERCIAL BANKING CORPORATION, its successors, or assigns upon demand, all the said obligations of the principal when due.

The undersigned expressly waives all rights to presentment for and notices of dishonor and/or protest, and agrees that the securities of every kind, that are now and may hereafter be left with the RIZAL COMMERCIAL BANKING CORPORATION, its successors, indorsees or assigns as collateral to any evidence of debt or obligations or upon which a lien may exist thereto, may be withdrawn or surrendered at any time, and the time of payment thereof extended, without notice to, or consent by the undersigned and the liability on this guaranty shall be solidary, direct and immediate and not contingent upon the pursuit by the RIZAL COMMERCIAL BANKING CORPORATION, its successors, indorsees or assigns, or whatever remedies it or they may possess, and the undersigned will at any time on demand when said obligations are due, pay to the RIZAL COMMERCIAL BANKING CORPORATION the above-mentioned obligation of the principal.

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The herein undersigned shall be released from its liability under this guaranty only after the principal or said undersigned has fully satisfied or paid its above-mentioned obligations with the RIZAL COMMERCIAL BANKING CORPORATION.

IN WITNESS WHEREOF, the undersigned hereunto affixed their signature at the Municipality of Makati, Province of Rizal on this _____ day of December, 1963.

(Signatures and acknowledgement omitted.)

APPENDIX B

Excerpts From
CIVIL CODE OF THE PHILIPPINES

Book IV.—Obligations and Contracts

Title I.—Obligations

Chapter 3, Section 4.—Joint and Solidary Obligations

Art. 1207. The concurrence of two or more creditors or of two or more debtors in one and the same obligation does not imply that each one of the former has a right to demand, or that each one of the latter is bound to render, entire compliance with the prestation. There is a solidary liability only when the obligation expressly so states, or when the law or the nature of the obligation requires solidarity.

Art. 1208. If from the law, or the nature or the wording of the obligations to which the preceding article refers the contrary does not appear, the credit or debt shall be presumed to be divided into as many equal shares as there are creditors or debtors, the credits or debts being considered distinct from one another, subject to the Rules of Court governing the multiplicity of suits.

Title II.—Contracts

Chapter I, General Provisions

Art. 1311. Contracts take effect only between the parties, their assigns and heirs, except in case where the rights and obligations arising from the contract are not transmissible by their nature, or by stipulation or by provision of law. The heir is not

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liable beyond the value of the property he received from the decedent.

If a contract should contain some stipulation in favor of a third person, he may demand its fulfillment provided he communicated his acceptance to the obligor before its revocation. A mere incidental benefit or interest of a person is not sufficient. The contracting parties must have clearly and deliberately conferred a favor upon a third person.

Chapter 2, Essential Requisites of Contracts— General Provisions

Art. 1318. There is no contract unless the following requisites concur:

- (1) Consent of the contracting parties;
- (2) Object certain which is the subject matter of the contract;
- (3) Cause of the obligation which is established.

Chapter 2, Essential Requisites, etc.—Section 1. — Consent

Art. 1319. Consent is manifested by the meeting of the offer and the acceptance upon the thing and the cause which are to constitute the contract. The offer must be certain and the acceptance absolute. A qualified acceptance constitutes a counter-offer.

Acceptance made by letter or telegram does not bind the offerer except from the time it came to his knowledge. The contract, in such a case, is presumed to have been entered into in the place where the offer was made.

Art. 1330. A contract where consent is given through

mistake, violence, intimidation, undue influence, or fraud is voidable.

Art. 1331. In order that mistake may invalidate consent, it should refer to the substance of the thing which is the object of the contract, or to those conditions which have principally moved one or both parties to enter into the contract.

Mistake as to the identity or qualifications of one of the parties will vitiate consent only when such identity or qualifications have been the principal cause of the contract.

A simple mistake of account shall give rise to its correction.

Art. 1333. There is no mistake if the party alleging it knew the doubt, contingency or risk affecting the object of the contract.

Chapter 2, Cont.—Section 3.—Cause of Contracts

Art. 1350. In onerous contracts the cause is understood to be, for each contracting party, the prestation or promise of a thing or service by the other; in remuneratory ones, the service or benefit which is remunerated; and in contracts of pure beneficence, the mere liberality of the benefactor.

Art. 1351. The particular motives of the parties in entering into a contract are different from the cause thereof.

Art. 1354. Although the cause is not stated in the contract, it is presumed that it exists and is lawful, unless the debtor proves the contrary.

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Title XV.—Guaranty

Chapter 1, Nature and Extent of Guaranty

Art. 2047. By guaranty a person, called the guarantor, binds himself to the creditor to fulfill the obligation of the principal debtor in case the latter should fail to do so.

If a person binds himself solidarily with the principal debtor, the provisions of Section 4, Chapter 3, Title I of this Book shall be observed. In such case the contract is called a suretyship.

Art. 2048. A guaranty is gratuitous, unless there is a stipulation to the contrary.

Art. 2065. Should there be several guarantors of only one debtor and for the same debt, the obligation to answer for the same is divided among all. The creditor cannot claim from the guarantors except the shares which they are respectively bound to pay, unless solidarity has been expressly stipulated.

The benefit of division against the co-guarantors ceases in the same cases and for the same reasons as the benefit of excussion against the principal debtor.

Chapter 3, Extinguishment of Guaranty

Art. 2079. An extension granted to the debtor by the creditor without the consent of the guarantor extinguishes the guaranty. The mere failure on the part of the creditor to demand payment after the debt has become due does not of itself constitute any extension of time referred to herein.

APPENDIX C

**THE COURT'S OPINION AND ORDER DENYING
PLAINTIFF'S MOTIONS FOR JUDGMENT
N.O.V., OR FOR NEW TRIAL**

This matter is before me on plaintiff's motion to set aside the general and the special verdicts in favor of the defendant and the judgment entered thereon, and to here enter a judgment in favor of the plaintiff, notwithstanding such verdicts or, in the alternative, that the plaintiff be granted a new trial.

The motions present serious questions of Philippines law. Unfortunately, the decisional law of that Nation was not available until the eve of trial. Without fault of counsel, some of the legal theories were not presented until after the trial was commenced.

The action is based on a document, designated an undertaking, in favor of plaintiff and admittedly signed by the defendant and another. The three principal defenses interposed by defendant were: (1) under Philippines law there was no consideration for signing the agreement, (2) under Philippines law there was no valid cause for signing the agreement, and (3) defendant signed the alleged agreement under a mistake going to the substance of the subject matter of the contract.

In the pre-trial order, the defendant advanced the defense that plaintiff granted the principal in the instrument an extension of time for payment, which extension, as a matter of law, voided the agreement. On this legal issue, I ruled against the defendant. Quite candidly, I now doubt the validity of that ruling. In any event, the cause was submitted to the jury on the issues of cause, consideration and mistake. The

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jury returned a general verdict in favor of defendant and a special verdict finding in favor of the defendant on each of the issues submitted. On the pending motion, the plaintiff urges that:

(1) Under Philippines law, there was valid cause for defendant's execution of the undertaking;

(2) In the alternative, and if and to the extent that consideration for a guaranty is required under Philippines law, there was also consideration for the undertaking; and

(3) Under Philippines law, the signature of the defendant was not placed on the undertaking as a result of a mistake going to the substance of the subject matter, in that if the defendant did not then know the substance of the undertaking, his ignorance thereof was due solely to his own negligence.

That the defendant had a substantial interest in the profits of Big Chrome, the principal in the undertaking, there is no doubt. He was contractually committed to work for that company for ten years as a field manager. He knew that the principal needed \$300,000.00 in order to purchase the necessary equipment, and that he and Fogelstrom were under a duty to secure this financing for the company. Certainly, his investment of \$48,000.00 in Big Chrome was substantial. A part of this was to be used to obtain financial backing. Big Chrome's equipment purchases included a substantial sum of his own equipment, plus other equipment which he purchased for the project. Without going into further detail, I express the opinion that there was valid cause for defendant's execution of the undertaking. Although cause is unknown to the Anglo-American common law, it is recognized in the civil law of Louisiana, the Canal

Zone, Puerto Rico and the Philippines. An excellent article on the subject is in the May, 1919, issue of the Yale Law Journal. Moreover, I have no difficulty in finding that there was a valid consideration for defendant's execution of that instrument. These conclusions, of course, are bottomed on the assumption of an otherwise valid undertaking.

I have much greater difficulty in disposing of the issue on mistake.

Defendant, who made a rather impressive witness, testified that he first learned of the letter of credit which had been issued by the plaintiff from Mr. Fogelstrom. Prior to that he had understood that the financing was probably going to be arranged through the Equitable Bank. At no time did he agree to become a guarantor in connection with the letter of credit, nor had he been advised of any conditions that the bank might impose in connection with the issuance of the letter. Defendant concedes that his signature is on the undertaking. His explanation is that on the day in question, Mr. Ang and Mr. Fogelstrom contacted him in Manila and said that they should go to the Rizal Bank, where there were some papers that should be signed in order to allow Big Chrome to get certain shipping documents for a customs clearance and a tax exemption. In answer to a question as to his understanding as to why his signature was needed on the instrument, he stated: "Not being in the shipping business, or not knowing anything about the export business, I didn't know of any reason why I should sign other than I was going to assemble this machinery . . . or some reason to get these shipping documents to be taken to customs . . . to get them cleared through customs." On this belief, he said he was relying on the statements of Ang and Fogel-

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strom. An officer of the bank produced the papers and asked defendant and Mr. Fogelstrom "to look at them and to sign them." First the papers were signed by Fogelstrom and then defendant signed. Again quoting from defendant's testimony: "I glanced at the top and it said, 'Undertaking,' I never read the whole thing, because they told me that this was a necessary thing and everybody else signed, so I figured if they had the nerve to do it, why, I also did." He said he did not read the instrument. He figured that the paper was connected with the shipment and that they needed his signature in order to release the *documents* to Big Chrome. Fogelstrom had already signed and made a special request that the defendant sign the instrument. Specifically, defendant testified that if he had known, at that time, that the document was a guarantee, or that it related to solidary liability, or joint or several liability with Big Chrome, he would not have signed.

Defendant, on his defense of mistake, relies on Articles 1318, 1330 and 1331 of the Civil Code of the Philippines, as construed in *Andrea Dumasug v. Felix Modela*, 34 Phil. 252, and in *Gillermo Monserrat, et al, v. M. Ruiz Highway Transit, Inc., et al*, C.A.-C.R. No. 17416-R, July 27, 1959, and similar cases. To be kept in mind is that defendant's claim of mistake is based on not knowing the nature or kind of instrument he was signing, rather than claiming that he misunderstood the language of the instrument. Simply stated, defendant relies on the rule stated in Williston on Contracts, 3d Ed., Vol, 1, Section 95A, as follows:

" . . . If without negligence on his part, a signer attaches his signature to a paper assuming it to be a paper of a different character, the

paper is void. Such a mistake as to the character of the instrument may relate to its existence as a contract or legally operative document of any kind, or to whether it is the kind of contract or legal document which it purports or is represented to be. . . ." (Page 351.)

Later cases recognizing this rule are *Gardner v. Rubin*, 149 Cal. App. 2d 368, 308 P.2d 892 (1957), *Hagen v. Gallerano*, 66 N.J. Super. 319, 169 A.2d 186 (1961), *Williams v. Robinson*, 98 So. 2d 844 (La. 1957). I express the belief that this Rule is in line with the provisions of the Philippine Code just mentioned and the interpretation thereof by the Philippine Courts.

The cases cited by plaintiff are to be distinguished from those supporting the rule just stated, in that: (1) in plaintiff's cases the parties seeking relief understood and appreciated the nature of the document being signed, and (2) none of those cases involved the construction of Article 1331 of the Civil Code of the Philippines, nor do they mention "a mistake going to the substance of the subject matter."

Although defendant's evidence is somewhat vague and his line of defense is rather thin, I find that the evidence on mistake was sufficiently clear to submit to the jury under proper instructions and hold that it was so submitted. At least, no exception was taken to the form of the instruction on mistake. Defendant was forceful in his testimony that he did not know the nature or the kind of the instrument he signed and was then of the belief that it was some document for use with the customs officials and for tax purposes. The jury having held in favor of defendant on this issue, the motion for a directed verdict and for

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a judgment notwithstanding the verdicts must be denied.

Plaintiff's alternative motion for a new trial on the ground that the verdicts in this case were against the clear weight of the evidence is addressed to the sound discretion of the Court. While I personally feel that the weight of the evidence is in favor of plaintiff's contentions, I likewise feel the evidence on mistake was sufficient to go to the jury. I do not feel that anything would be gained by granting a new trial. The Court would still be faced with the same legal issues as were raised on the pending motions and in the former trial. Sooner or later, these problems must be presented to the Court of Appeals. To grant a new trial would only postpone the ultimate conclusions of the Court of Appeals.

Accordingly, the motion for a new trial is denied.

Defendant's Motion for a Directed Verdict

Defendant's counsel again urge their contention that plaintiff granted to Big Chrome an extension of time within which to pay the indebtedness and that such extension, without the consent of the defendant, extinguished the guarantee. On trial, the defendant introduced evidence in support of this contention and as I see it, there is no question but that an extension of time was actually granted and that the defendant did not consent to such extension or extensions.

A reappraisal of the defendant's position in the light of the evidence of the case, forces a conclusion that my decision of January 10, 1968, upholding plaintiff's contention is on rather tenuous ground. On trial, the experts on Philippines law were in agree-

ment that even though the guarantor's liability was solidarity, direct and immediate, that liability would be extinguished, if time for payment was extended without the guarantor's consent. I am not at all certain that the language of the undertaking on which I previously relied to a large extent¹ applies to a "release," as a matter of law, rather than a voluntary "release." It is now forcibly argued that a voluntary release is to be distinguished from a situation where the liability is extinguished due to a failure to obtain the guarantor's consent to an extension of time, and that such a release is involuntary and occurs by operation of law. Moreover, I am now impressed with the argument that the particular provision was inserted to make it clear that the right of division—that is, the right to divide the amount of indebtedness among the guarantors—did not exist. By this language, the bank was making it clear that it was not obligated to give a release until the principal, or the guarantor, paid the indebtedness in full. My confidence in my previous memorandum is considerably shaken when I apply *Radio Corp. of The Philippines v. Roa*, 62 Phil. 211, to the facts as produced in evidence.

Certainly, this legal issue is not without its difficulties. If it was the only issue involved, I might well reverse my hasty decision on the eve of the trial and accept the defendant's views. Here, again, I shall leave the ultimate decision to higher authority and deny defendant's pending motion.

¹ "The herein undersigned shall be released from its liability under this guaranty only after the principal or said undersigned has fully satisfied or paid its above-mentioned obligations with the Rizal Commercial Banking Corporation."

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Plaintiff's and defendant's motions should be denied.

IT IS SO ORDERED.

DATED this 14th day of March, 1968.

JOHN F. KILKENNY
District Judge

No. 23018

United States
COURT OF APPEALS
for the Ninth Circuit

RIZAL COMMERCIAL BANKING CORPORATION,
a corporation,

Appellant,

v.

NED PUTNAM,

Appellee.

APPELLEE'S ANSWERING BRIEF AND
OPENING BRIEF UPON CROSS-APPEAL

*Appeal from the United States District Court,
for the District of Oregon*

HONORABLE JOHN F. KILKENNY, Judge

DAVIES, BIGGS, STRAYER, STOEL AND BOLEY
CLEVELAND C. CORY
CLARENCE R. WICKS
DON H. MARMADUKE

1110 Yeon Building
Portland, Oregon 97201

Attorneys for Appellee

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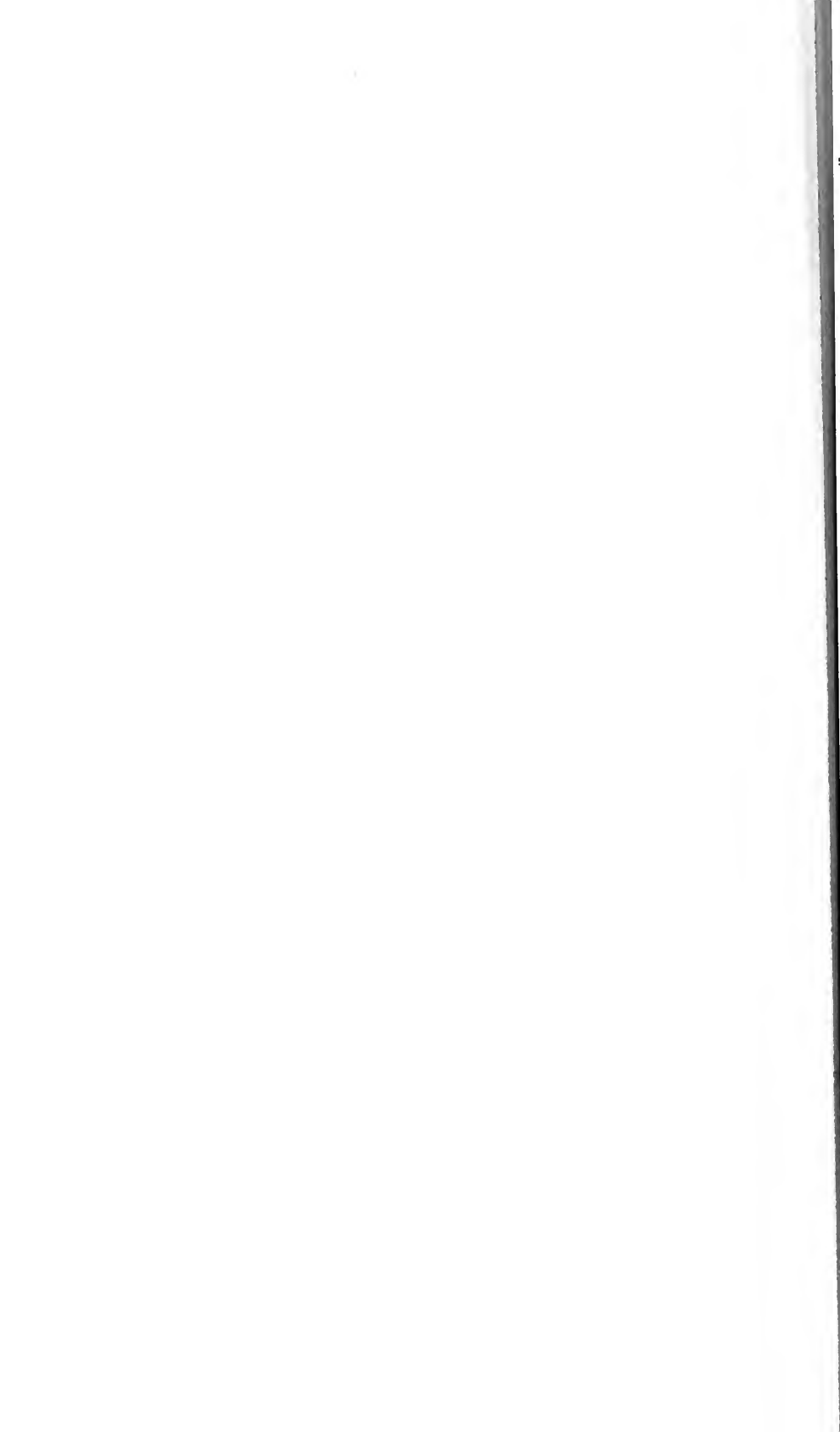
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United States
COURT OF APPEALS
for the Ninth Circuit

RIZAL COMMERCIAL BANKING CORPORATION,
a corporation,

Appellant,

v.

NED PUTNAM,

Appellee.

APPELLEE'S ANSWERING BRIEF

*Appeal from the United States District Court
for the District of Oregon*

HONORABLE JOHN F. KILKENNY, Judge

STATEMENT OF THE ISSUES PRESENTED

This is an appeal from a judgment for defendant entered upon both a general and special verdict of the jury (R. pp. 41, 42). Plaintiff concedes that the jury was instructed correctly on the applicable law of the Philippines. Thus, the Court's only inquiry as to the validity of the "Undertaking" is whether ". . . it cannot be said that reasonable men could

reach differing conclusions on the issues". [*Commissioner v. Duberstein*, 363 U.S. 278, 290-1, 80 S. Ct. 1190, 4 L. E.2d 1218, quoted in *Woody v. U. S.*, 368 F.2d 668, 671 (C.A. 9)].

May this Court review the district court's alternative order under Rule 50(b) denying plaintiff's motion for a new trial made "on the ground that said verdicts are against the clear weight of the evidence and will result in a serious miscarriage of justice" (R. p. 46) ?

STATEMENT OF THE CASE

Defendant does not dispute plaintiff's statement of the case. However, it is significant to this appeal that plaintiff took no exception to the form of the special verdict (R. p. 42), or to the trial court's instructions as to the law of the Philippines on "cause," "consideration," and "mistake" (Tr. pp. 329-332).

STATEMENT OF THE FACTS

Defendant does not quarrel with plaintiff's statement of the facts, so far as it goes. However, we believe it is necessary to set out other significant testimony of defendant which negatives plaintiff's suggestion of defendant's "total involvement" in the transaction giving rise to the undertaking (App. Br. p. 3).

With reference to Paragraph Second of the Agreement of June 7, 1963 which stated in part "That the PARTIES OF THE SECOND PART shall secure

credit accommodations from a local bank to enable the PARTY OF THE FIRST PART to open a Letter of Credit . . ." for the importation of the mining equipment, Putnam was asked (Tr. pp. 154-155) :

"Q. Now, would you refer to the second paragraph, I think it is, on Page 2, where it refers to the securing of credit accommodations? I might point out, Mr. Putnam, that it first identified you and Mr. Fogelstrom as parties of the second part, and it says:

'That the parties of the second part shall secure credit accommodations from a local bank to enable the party of the first part to open a Letter of Credit.'

Did you have anything to do with that?

A. The only thing I had to do with it is they asked me to send letters of recommendation or letters from my bank introducing me to the Equitable Banking Corporation and another bank, the United Philippine Bank, I believe—I don't remember whether it was the Republic Bank. I can't remember the other bank that it was sent to.

Q. Other than those two letters did you have anything to do with the letter of credit in any way?

A. Nothing.

Q. By the way, when did you first hear of the Rizal Bank?

A. It was in August or September sometime before I heard of it. I believe in August.

Q. All right. Now, that same Exhibit 1, in the next paragraph, I think it is, refers to the requirement that you and Mr. Fogelstrom provide

\$60,000 as a marginal deposit. Did you do that?

A. Yes.

Q. I think the agreed facts show that the amount was actually \$96,000 that you sent.

A. Yes. I sent \$48,000 and Mr. Fogelstrom sent \$48,000.

Q. Of that amount sixty-seven thousand plus dollars was used for the deposit. What about the balance of it? Where did that go?

A. The balance was to be used to assemble machinery on the property and move it to the mining site and assemble it."

Putnam also testified that he had never heard of the plaintiff bank until Fogelstrom told him that a letter of credit had been established in Manila and that he had never at any time agreed to become a guarantor in connection with the letter of credit (R. pp. 161-162):

"Q. Now, I asked you earlier about when you first learned about the plaintiff, and you answered that. From whom did you learn about the plaintiff bank, the Rizal Bank?

A. I learned about the Rizal Bank from Mr. Fogelstrom. He told me that a letter of credit had been established in Manila with the Rizal Bank.

Q. Had you had anything to do with that letter of credit?

A. I never heard of it before.

Q. Who did handle that?

A. It was handled by Bernabe Ang.

Q. Of the Philippine Discal office?

A. Yes.

Q. At the time that he was working on that

did you know where that was being arranged or with what bank?

A. No. I understood that it was going to be with the Equitable Bank, because on several occasions these people mentioned a fellow by the name of Peter. I never did learn what his last name was.

Q. Did you at any time agree to become a guarantor in connection with the letter of credit?

A. No.

Q. Or were you aware of any conditions that the bank imposed in connection with the issuance of the letter of credit?

A. No."

With respect to the events in the morning of December 13, 1963 when Putnam was asked by Ang and Fogelstrom to go to the Rizal Bank to sign "... some papers out there that would have to be signed in order to allow Big Chrome to get the shipping documents so they can get their Customs clearance and their tax exemption" (Tr. p. 163), Putnam was asked as to his understanding as to why his signature was needed (id.):

"A. Not being in the shipping business, or not knowing anything about the export business, I didn't know of any reason why I should sign other than if I was going to assemble this machinery and be a tax exemption they may want me to sign.

Q. I see. In connection with the tax exemption?

A. Or some reason to get these shipping documents to be taken to the Customs.

Q. To get them cleared through Customs?

A. To get them cleared through Customs."

On this subject, he further stated (Tr. p. 165):

"Q. In other words, it related to getting the documents through Customs or the equipment through Customs?

A. Yes. I had heard that banks there don't turn loose papers over there until everything is in order, and I figured that this was—my being implicated in the shipment, having built some of this machinery, that maybe they needed my signature to release these documents to Big Chrome."

With reference to signing the document, Putnam testified (id.):

"Q. While Mr. Chiong was in the room did he make any explanation to you as to what the document was?

A. No.

Q. Did he refer to a guarantee in any way?

A. No, he didn't.

Q. What did he refer to? Did he describe solidary liability in any way?

A. No, he did not.

Q. Do you recall Mr. Pineda being present?

A. No, I don't remember Mr. Pineda at all.

Q. Did anyone else from the bank make any explanation to you as to what the document was or what its effect was?

A. No. They asked for my passport, and I didn't have my passport, but I had my passport number in my head, so I gave them the number and the date of issue.

Q. May I ask you this, Mr. Putnam: If you

had known at that time that this document was a guarantee or that it related to the solidary liability or joint and several liability for Big Chrome, would you have signed the document?

A. No, I would not."

On cross-examination, Mr. Putnam testified as follows with respect to Paragraph Second of the Agreement of June 7, 1963 (Ex. 1) (Tr. pp. 205-207):

"Q. Mr. Putnam, will you please describe to the jury the discussions and negotiations between yourself and Mr. Fogelstrom, on the one hand, and Big Chrome on the other hand, that resulted in this provision in the agreement?

A. I never entered into any of these discussions with Big Chrome myself. This was all brought to me after Fogelstrom had done the negotiations with Big Chrome.

Q. Did you make any inquiries before signing this contract as to why you personally should be obligated to get a \$300,000 credit for Big Chrome?

A. This was discussed with me almost every evening, at least, regarding what they were accomplishing, and the methods that they may go about—different things within this contract before it was signed. This second portion, securing credit accommodations, the Discal office in Manila was working on that for the Big Chrome people. It so happened that they were working with two other banks besides this Rizal Bank. I had never heard about this Rizal Bank before, until after a letter of credit was opened. I was here in the United States.

Now, this portion—I fulfilled my part, the

part that they asked me to do, by having my Branch Manager here, the bank that I do business now with, the Branch Manager sent letters of recommendation to two banks that they asked me to send this information to. I supposed that they were working with these two banks.

Q. Yes. But my question to you, Mr. Putnam, was as to the discussion and negotiations before you signed this contract. Did you interpose any objection to being obligated to get a \$300,000 bank credit for Big Chrome?

A. No. The Discal office in Manila was handling that. I felt certain that they were going to do it, although at this stage there were many opportunities available to finance this thing."

With respect to events on December 13, 1963 when the undertaking was signed, Putnam testified on cross-examination (Tr. p. 213):

"Q. On December 13th, the day that you signed the undertaking, isn't it a fact that you were told before you went to the bank—you were told at the Manila Hotel by Mr. Fogelstrom that you had to sign a guarantee?

A. No."

On the subject of his understanding, Putnam further stated on cross-examination (Tr. pp. 216-218):

"Q. You testified yesterday that you understood you were only signing papers that were necessary for Customs or tax purposes. Were you an officer of Big Chrome?

A. No.

Q. Did anyone tell you why your signature was required on Customs documents or tax doc-

uments on behalf of Big Chrome?

A. No.

MR. HART: Will you hand the witness, please, Exhibit 10?

Q. You testified yesterday that that document was put in your hands there in the office and that you saw the word "Undertaking" at the top of it. Is that correct?

A. Yes.

Q. Did you think that that looked like a Customs document or a tax document?

A. There is many words in here that would lead you to believe that this was a document to sign to receive the papers regarding the loan, the advances, letters of credit, trust receipts and the drafts, and this would lead me to believe—"

* * * * *

"Q. Did Mr. Chiong ask you to read it? Didn't you testify yesterday that Mr. Chiong asked you to read it?

A. No, he didn't.

Q. I think you said that Mr. Fogelstrom assured you that it was all right and therefore you didn't read it; is that correct?

A. That is right."

SUMMARY OF ARGUMENT

There is substantial evidence in this record from which the jury could have found in answer to the special interrogatories (R. p. 42):

1. That the undertaking was not supported by "cause," as defined in the trial court's instructions;

2. That the undertaking was not supported by "a consideration," as defined in the trial court's instructions;

3. That in connection with execution, defendant made a mistake sufficient to avoid the undertaking, under the law stated in the trial court's instructions.

Therefore, the judgment appealed from should be affirmed.

The trial court's denial of plaintiff's motion for a new trial on the ground that the general and special verdicts were ". . . against the clear weight of the evidence and will result in a serious miscarriage of justice" (R. p. 46), is not reviewable by this Court. Even if reviewable, plaintiff cannot show a gross abuse of discretion by the trial court.

ARGUMENT

I

The Trial Court Did Not Err in Denying Plaintiff's Motion for a Directed Verdict, or in Denying Plaintiff's Subsequent Motion for Judgment N.O.V.

A. The jury could find on this record that defendant's execution of the undertaking was not supported by "cause," or by "consideration," as defined in the trial court's instructions.

1. The Trial Court's Instructions

As pointed out above, the jury gave negative answers to interrogatories 1 and 2 to the effect that

the defendant's execution of the instrument designated as an undertaking was not supported by "cause," or "consideration," "as I have defined that word to you." (R. p. 42)

No objection was taken by plaintiff to the trial court's definition of "cause" or "consideration" under Philippine law (Tr. pp. 329-330):

"Now, the first issue of fact to be decided by you is whether there was a valid cause or consideration for the defendant's execution of the undertaking. Under Philippine law either cause or consideration for a promise is sufficient to constitute a binding agreement. Any reason of substance which may induce the execution of an agreement can be the cause of the agreement. Thus, any promise or performance of a thing or service by the other contracting party can be a sufficient cause to make the obligation binding. A consideration sufficient to support an agreement consists of the accrual to one party of some right, interest, profit, or benefit, or, on the other hand, some forbearance, detriment, loss or responsibility, given, suffered or undertaken by the other party."

In this case, on August 7, 1963 the plaintiff offered to issue the Letter of Credit to Big Chrome Exploration Co., Inc. on the condition, among others, that it be subject to the joint and several signatures of Ang Lam, Bernabe Ang, Wayne Fogelstrom and defendant (Ex. 5). However, the jury could find from defendant's testimony that at no time was he aware of this condition, and that he never agreed to

this condition (Tr. p. 162). While plaintiff did secure the signatures of Ang Lam and Bernabe Ang to an Undertaking on August 8, 1963, the date of the issuance of the Letter of Credit, it was content to proceed without obtaining any similar guarantee from Fogelstrom or defendant. Thus, plaintiff waived and relinquished any right it had to insist upon the joint and several guaranty of defendant as a condition of the issuance of the Letter of Credit. It follows that the prior issuance of the Letter of Credit could not furnish a sufficient "cause" or "consideration" for defendant's execution of the Undertaking some four months later. At least, the jury could have so found under the foregoing instructions of the court.

On this point, plaintiff argues that by reason of the Agreement of June 7, 1963 (Ex. 1), the defendant ". . . must have known in signing it that Big Chrome was unable to obtain its own financing, and that *some* bank had agreed to issue the proposed letter of credit only if he and Fogelstrom (instead of Big Chrome) were responsible for obtaining it. From this it was surely clear to Putnam that the letter of credit was to be issued in reliance on Fogelstrom's and his financial responsibility; there could have been no other reason for requiring two foreigners to obtain a letter of credit for a local company." (App. Br. pp. 48-49).

The short answer is that the jury rejected this type of argument. Presumably, the jury accepted defendant's testimony that at no time in 1963 was he

aware of any commitment or condition requiring him to guaranty Big Chrome's obligation. Furthermore, in considering the language employed in the Agreement of June 7, 1963, the jury could have reasonably concluded that when the parties wished to assume a monetary obligation, they spelled out the exact extent of such a commitment, as in paragraph THIRD where Fogelstrom and Putnam agreed to ". . . pay on their own account the amount of U. S. \$60,000.00 as marginal deposit for said letter of credit." The obligation of Fogelstrom and Putnam to "secure credit accommodations from a local bank" to enable Big Chrome to open a letter of credit is obviously vague and imprecise. Putnam testified that he fulfilled his obligation in this respect by sending letters of introduction from his own bank to certain Philippine banks and that the Discal office in Manila was handling the issuance of the letter of credit (Tr. p. 154, 206).

On December 13, 1963 when Putnam signed the Undertaking he certainly did know that the bank had previously issued its letter of credit to Big Chrome. Plaintiff argues, therefore, that Putnam "presumably understood" that he could not refuse to execute a guaranty of the letter of credit (App. Br. p. 49). However, the jury was not required to draw plaintiff's proposed inference. The jury could believe Putnam's testimony that he knew nothing about any claimed obligation to execute a guaranty for Big Chrome. Thus, the jury could reasonably infer that Putnam had no reason of substance to execute the

guaranty and that no right, interest, profit, or benefit accrued to him thereby.

Plaintiff also argues that Putnam's substantial participation in the Big Chrome venture provided him with ample cause for executing the Undertaking. In this respect, plaintiff's argument was adopted by the trial court in its order on plaintiff's Motion for Judgment n.o.v. (R. pp. 82-83).

Furthermore, plaintiff argues that under Putnam's own version of the transaction on December 13, 1963, cause or consideration was established since he signed the paper to allow Big Chrome to get the shipping documents so they could obtain their Customs clearance and their tax exemption (App. Br. p. 52).

Putnam's participation in the venture which motivated his willingness to sign a paper so that Big Chrome could procure the shipping documents could not legally amount to "cause" or "consideration."

Plaintiff's argument confuses the personal motive which Putnam may have had with "cause" or "consideration" for the execution of the Undertaking.

Under the Philippine law the motives of a party do not affect the validity of the contract and the presence of a motive can not cure the defect of absence of cause or consideration in a contract. Article 1351 of the Civil Code declares (App. Br. Appendix p. 5):

"The particular motives of the parties in entering into a contract are different from the cause thereof."

Thus, the "consideration" or "cause" for Putnam's execution of the Undertaking was not his personal motive or desire to help Big Chrome obtain possession of the shipping documents. This mistaken motive was totally different than the ordinary benefit, "cause" or "consideration" moving to Big Chrome through the plaintiff's issuance of the letter of credit because of Putnam's execution of the Undertaking. However, as noted above, the issuance of the letter of credit in August, 1963 could not supply the cause or consideration for defendant's execution of the Undertaking over four months later.

The cited case of *Bank of the Philippines v. Foerster, Administrator*, 49 Phil. 843 (App. Br. p. 53) is not applicable here for the following reasons: (a) Putnam was not an officer of Big Chrome; (b) at the time of the signing of the Undertaking he was not familiar with the financial affairs of Big Chrome; (c) he was not aware of, or a party to, the arrangements that had been made in connection with the issuance of the letter of August 8, 1963; (d) he had not agreed to act as a guarantor for Big Chrome, and (e) by providing half of the funds that were used in making the marginal or time deposit, he had fulfilled the only monetary commitment he had made with respect to obtaining the credit.

Plaintiff also argues that a guaranty can be construed to cover a loan granted prior to the execution of the guaranty. However, in the *Foerster* case this result was reached only because the guarantor was so

intimately involved with arrangements for the loan that it clearly could be said that all of the parties intended that the guaranty should cover the prior advances. In fact, while the corporation had drawn against the credit earlier, the written agreement covering the loan was executed simultaneously with the bond or guaranty. Thus *Foerster* is distinguishable from the case at bar where, in view of the jury's finding, it cannot be said that Putnam intended to guarantee the previously issued Letter of Credit. In other words, the circumstances surrounding the signing of this Undertaking would not support a presumption that there was a cause or consideration, and would not justify making the instrument operate retrospectively.

Plaintiff also contends that the release of the shipping documents pursuant to the execution of a trust receipt supplied the necessary "cause" or "consideration." The answer to this is that the plaintiff stipulated that the security for this transaction was to be a chattel mortgage (Pretrial Order, R. p. 12). Also, plaintiff's executive committee determined that there was to be no advance to Big Chrome in the form of a trust receipt (Ex. 2). The evidence here showed that there was no necessity to delay the execution of the chattel mortgage, and that it could have been executed simultaneously with the release of the documents. However, even if this could not have happened, the bank was aware of this fact when it conditioned the issuance of the Letter of Credit upon the execution of the chattel mortgage, so that if Big Chrome needed

the shipping documents in order to place itself in position to execute the mortgage, the plaintiff was obligated to release the documents so that this could be accomplished. Therefore, plaintiff acted wrongfully in conditioning the release of the documents upon the execution of the trust receipt, and the transaction could not furnish "cause" or "consideration" for the Undertaking.

To summarize, the execution of the Undertaking on December 13, 1963 benefited only the plaintiff, since its effect was merely to constitute defendant the bank's insurer. At this point, defendant and Big Chrome had nothing further to gain by extending a guaranty. The bank was already unconditionally bound to make the payments on the letter of credit, and, as mentioned above, had no right to withhold the release of the goods. Therefore, "consideration" or "cause" for defendant's execution of the Undertaking could not be supplied by release of the shipping documents, nor by the subsequent execution of the trust receipt.

B. The jury could find on this record that in executing the Undertaking defendant made a mistake sufficient to avoid the undertaking under the legal standard stated in the court's instructions.

1. *The Issue of Defendant's Negligence or Fault is not Properly Before this Court.*

At the outset, the Court will note that the gist of plaintiff's argument on the mistake issue is that "...

Putnam's deliberate election not to read the Undertaking before signing it constituted negligence as a matter of law, so that he cannot avoid liability under the Undertaking on the ground of mistake." (App. Br. pp. 57, 66).

However, the issue of defendant's negligence was not raised in plaintiff's contentions in the pretrial order, or in the issues of fact (R. pp. 14-22, 27-28). In moving for a directed verdict at the close of the evidence, the only contention of plaintiff's counsel on the issue of mistake was ". . . that a witness who elects to sign without reading thereby takes the burden of the obligation . . ." (Tr. p. 306). Plaintiff's Motion for Judgment n.o.v. first alleged defendant's negligence (R. p. 45):

"3. Under Philippines law, the signature of the defendant was not placed on the Undertaking as a result of a mistake going to the substance of the subject matter, in that if the defendant did not then know the substance of the Undertaking, his ignorance thereof was solely due to his own negligence;"

Rule 50(a) of the Federal Rules of Civil Procedure expressly provides that a motion for a directed verdict "shall state the specific grounds therefor." Rule 50(b) states that not later ". . . than 10 days after entry of judgment, a party who has moved for a directed verdict may move to have the verdict and any judgment entered thereon set aside and to have judgment entered in accordance with his motion for a directed verdict."

In construing this rule, several federal appellate courts have followed the rule that grounds not asserted in the motion for a directed verdict can not be included in the later post-judgment motion (*Glazer v. Glazer*, 374 F.2d 390, 400 (C.A. 5) cert. den. 389 U.S. 831, 88 S. Ct. 100, 19 L. Ed. 2d 90; *Ralston Purina Company v. Parsons Feed & Farm Supply*, 364 F.2d 57, 59-60 (C.A. 8); cf. *U.S. v. Fenix & Scisson, Inc.*, 360 F.2d 260, 265 (C.A. 10); and see 2B *Barron & Holtzoff, Federal Practice & Procedure*, 411, § 1079). This construction is impelled by the language of Rule 50(b) that any judgment n.o.v. is to be entered "in accordance with his motion for a directed verdict."

Accordingly, this Court's review of the sufficiency of the evidence to support the jury's finding of "mistake" should be limited to plaintiff's contention on the motion for a directed verdict that one who signs without reading an instrument takes the burden of the obligation.

2. *The Trial Court's Instructions.*

As heretofore pointed out, the jury gave an affirmative answer to interrogatory No. 3 to the effect that in signing the instrument a mistake was made by the defendant sufficient to avoid the understanding under "... the law as I have stated it to you" (R. p. 42).

No objection was taken by plaintiff to the trial court's definition of "mistake," an explanation which

quoted the requirements of Article 1331 of the Civil Code of the Philippines (Tr. pp. 329-330):

“Under Philippine law, a contract where consent is given through mistake, is voidable. In order that mistake may invalidate consent, it should refer to the substance of the thing which is the object of the contract, or to those conditions which have principally moved one or both parties to enter into the contract. There would be no mistake if the defendant knew the doubt, contingency or risk affecting the object of the contract. Consequently, in this case, the defendant cannot claim a consent by mistake if he knew the contingency of the risk affecting the object of the guaranty, which is Plaintiff’s Exhibit 10. On the other hand, if you find from a preponderance of the evidence in the case that the defendant, through no negligence or fault of his own, did not know or appreciate that the undertaking required him to be a guarantor or surety for Big Chrome, and that the defendant did not intend to take on this responsibility, but only believed that he was signing papers which would permit Big Chrome to obtain a Customs clearance and tax exemption for the mining machinery and equipment, and that he acted as an ordinary, prudent person under the then existing circumstances and conditions, then your verdict must be against the plaintiff and in favor of the defendant. The burden of proof is on the defendant on this issue.”

In the case at bar, the jury could have reasonably found the following facts from which to draw an inference that defendant’s mistake referred “. . . to the substance of the thing which is the object of

the contract, or to those conditions which have principally moved [defendant] to enter into the contract”:

A substantial portion of the machinery and equipment which Discal sold to Big Chrome had in turn been sold by Putnam to Discal. Some of the equipment had been fabricated by Putnam and he had worked in the preparation and assembly of most of the equipment. Therefore, when he was requested to go to the Bank on December 13, 1963 to sign some papers, he reasonably assumed that this was necessary because of his prior relationship with the goods. Moreover, when he arrived at the Bank, he reasonably understood that the papers had to be signed to permit Big Chrome to obtain the necessary Customs clearance and tax exception for the goods. No one told him that the document being signed was a guaranty or undertaking, or that he might thereby become bound as a guarantor or surety, and, as a matter of fact, he did not learn the nature of the document until March, 1964. He did not read the document, but this was excusable in view of the confidence which he placed in Wayne Fogelstrom. Fogelstrom was a vice president of Discal, a business concern with offices in California and in the Philippines, and was experienced in matters pertaining to the importation of goods. By contrast, this was the defendant's first experience with such a transaction.

Furthermore, and most important, the jury could have found from defendant's testimony that he was not aware that he was being asked to sign a guar-

anty or contract of suretyship, but that he believed he was signing something in the nature of a receipt or release of lien as seller of the machinery, and that he would not have signed the Undertaking had he known that it purportedly made him a guarantor or surety for Big Chrome.

It is not necessary to discuss the Philippine cases relating to Article 1331 of the Civil Code or to debate the applicability of the Philippine cases cited by plaintiff (App. Br. pp. 60-63), let alone the American cases not involving statutory provisions similar to Article 1331 (App. Br. pp. 63-66). On this point, we quote the district court's denial of plaintiff's motion for judgment n.o.v. (R. pp. 84-85) :

"Defendant, on his defense of mistake, relies on Articles 1318, 1330 and 1331 of the Civil Code of the Philippines, as construed in *Andrea Dumasug v. Felix Modela*, 34 Phil. 252, and in *Guillermo Monserrat, et al, v. M. Ruiz Highway Transit, Inc., et al*, C.A.-G.R. No. 17416-R, July 27, 1959, and similar cases. To be kept in mind is that defendant's claim of mistake is based on not knowing the nature or kind of instrument he was signing, rather than claiming that he misunderstood the language of the instrument. Simply stated, defendant relies on the rule stated in *Williston on Contracts*, 3d Ed., Vol. 1, Section 95A, as follows:

' . . . If without negligence on his part, a signer attaches his signature to a paper assuming it to be a paper of a different character, the paper is void. Such a mistake as to the character of the instrument may re-

late to its existence as a contract or legally operative document of any kind, or to whether it is the kind of contract or legal document which it purports or is represented to be. . . .' (Page 351.)

Later cases recognizing this rule are *Gardner v. Rubin*, 149 Cal. App. 2d 368, 308 P.2d 892 (1957), *Hagen v. Gallerano*, 66 N.J. Super. 319, 169 A.2d 186 (1961), *Williams v. Robinson*, 98 So. 2d 844 (La. 1957). I express the belief that this Rule is in line with the provisions of the Philippine Code just mentioned and the interpretation thereof by the Philippine Courts.

The cases cited by plaintiff are to be distinguished from those supporting the rule just stated, in that: (1) in plaintiff's cases the parties seeking relief understood and appreciated the nature of the document being signed, and (2) none of those cases involved the construction of Article 1331 of the Civil Code of the Philippines, nor do they mention 'a mistake going to the substance of the subject matter.' "

Finally, plaintiff refers to Article 1333 of the Civil Code which negatives mistake if defendant "... knew the doubt, contingency or risk affecting the object of the contract." Plaintiff suggests that the doubt or risk was whether the bank would release the shipping documents to Big Chrome, and defendant knew this; ergo, Article 1333 bars the claim of mistake.

In this respect, the trial court charged the jury (Tr. pp. 341-342):

"There would be no mistake if the defendant

knew the doubt, contingency or risk affecting the object of the contract. Consequently, in this case, defendant cannot claim a consent by mistake if he knew the contingency of the risk affecting the object of the guaranty, which is Plaintiff's Exhibit 10."

This instruction correctly focused the jury's attention on the narrow point that the claimed doubt, contingency or risk had to affect the object of the guaranty, which presupposes that defendant knew the object of the guaranty and, nevertheless, decided to take the risk of obligating himself on the contingency that the principal obligation would be fully paid by Big Chrome. As noted above, plaintiff took no exception to this instruction.

However, for the first time on appeal, plaintiff erroneously disregards this only true object of the guaranty and mistakenly argues that the object of the guaranty had nothing to do with the obligation thereunder, but that the "object" was "whether the Rizal Bank would release the shipping documents to Big Chrome."

Since it is based on a mistaken assumption, plaintiff's argument lacks merit, even if it was entitled to this Court's consideration. However, since this contention was not one of plaintiff's grounds for a directed verdict, or for judgment n.o.v. on the issue of "mistake," it cannot be considered on appeal (*Pacific Queen Fisheries v. Symes*, 307 F.2d 700, 719-721 (C.A. 9), cert. den. 372 U.S. 907, 83 S. Ct. 721, 9 L.

Ed. 2d 717; *U. S. for the Use of E. E. Black, Ltd. v. Price-McNemar Const. Co.*, 320 F.2d 663, 666 (C.A. 9); *Eason v. Dickson*, 390 F.2d 585, 589 (C.A. 9)).

II

The Trial Court Did Not Err in Denying Plaintiff's Alternative Motion for a New Trial, and said Order Should Not Be Reviewed by this Court.

A. The trial court exercised its sound discretion in denying plaintiff's motion for a new trial.

1. The Grounds of Plaintiff's Motion for a New Trial.

The grounds of plaintiff's alternative motion for a new trial were that the special and general verdicts "... are against the clear weight of the evidence and will result in a serious miscarriage of justice." (R. p. 46).

This motion was filed on January 23, 1968; all motions were argued before the trial court on February 7, 1968, by which time the court had briefs of counsel and a transcript of defendant's testimony (R. pp. 105-106, Tr. p. 345). After hearing lengthy argument (Tr. pp. 344-389) the trial court took the motions under submission and procured a transcript of the arguments (Tr. p. 389). Five weeks later, on March 14, 1968, the court filed its order denying plaintiff's motions (R. pp. 81-87). The court held that the evidence on mistake "... was sufficiently clear to submit to the jury under proper instructions and [I] hold that it was so submitted" (R. p. 85).

The court further stated that the "Defendant was forceful in his testimony . . ." on mistake (*id.*).

Turning then to plaintiff's alternative motion for a new trial, the court recognized that such a motion, when made on the ground that the verdicts were against the clear weight of the evidence, was "... addressed to the sound discretion of the Court" (R. p. 86). The judge then stated his personal feeling that "... the weight of the evidence is in favor of plaintiff's contentions. I likewise feel the evidence on mistake was sufficient to go to the jury" (*id.*). The court denied the motion for a new trial, stating that nothing would be gained by granting a new trial and that to do so would only postpone the ultimate conclusions of this Court.

Even though the record clearly shows that the trial court exercised its sound discretion and fully considered lengthy briefs and arguments of counsel, plaintiff urges that the record reflects a "plain abuse of the court's discretion" (App. Br. p. 69).

The basis of plaintiff's argument is that the trial court's observation: "I personally feel that the weight of the evidence is in favor of plaintiff's contentions" compelled an allowance of the new trial motion and that the court could not deny the motion for any other reason.

The weakness of plaintiff's position is that while the motion was grounded on the contention that the verdicts were "... against the clear weight of the evidence and will result in a serious miscarriage of

justice," the court did not so find. The court merely stated, in the role of a thirteenth juror, its personal feeling that the weight of the evidence favored plaintiff's contentions. In other words, if Judge Kilkenney had tried this action without a jury, he might have reached a different result. However, it is well settled that a trial judge may not invade the province of the jury by granting a new trial in a case, such as this, where the testimony was sharply in conflict. (*Duncan v. Duncan*, 377 F.2d 49, 52-55 (C.A. 6).) The correct rule is well stated in 6A *Moore's Federal Practice*, (2d Ed.) pp. 3818-3819, § 59.08:

"There are statements in the cases that, in ruling on the motion, the trial judge acts as a thirteenth juror. Properly understood and applied, no fault can be found with them for the judge does act to evaluate and weigh the evidence. But while he has a responsibility for the result no less than the jury, he should not set the verdict aside as against the weight of the evidence merely because, if he had acted as trier of the fact, he would have reached a different result; and in that sense he does not act as a thirteenth juror in approving or disapproving the verdict. And since the credibility of witnesses is peculiarly for the jury it is an invasion of the jury's province to grant a new trial merely because the evidence was sharply in conflict."

In this respect, the case at bar is similar to *Radlov v. Chernack*, 217 F. Supp. 33 (DCRI), aff'd 331 F.2d 170 (C.A. 1), which involved claims for breaches of alleged oral employment contracts, the existence of

which were denied by defendants. Following jury verdicts for plaintiff, defendants' motions for judgment n.o.v. and for a new trial were denied by the district judge who stated (217 F. Supp. at pp. 35-36) :

"In each of these actions the defendant denied the making of the agreement sued upon. The resolution of this fundamental issue in the light of the contradictory evidence presented by the parties was peculiarly within the province of the jury. The testimony of Messrs. Radlo and Chernack on this crucial issue was in irreconcilable conflict. It was for the jury to determine what were the true facts. In addition, many letters between the parties which related to this issue were introduced into evidence. The reasonable inferences to be drawn from these letters were likewise for the determination of the jury. After a careful review of the evidence and the reasonable inferences to be drawn from it, I am satisfied that there was ample evidence in the record to support the jury's verdicts, and that they do justice between the parties. In my opinion it would be an unwarranted invasion by me of the right to trial by jury if I were to set aside the verdict of the jury in either of these actions."

The most often quoted opinion on this subject was written by Judge Parker in *Aetna Casualty & Surety Co. v. Yeatts*, 122 F.2d 350, 352-353 (C.A. 4) :

"On such a motion it is the duty of the judge to set aside the verdict and grant a new trial, if he is of opinion that the verdict is against the clear weight of the evidence, or is based upon evidence which is false, or will result in a miscar-

riage of justice, even though there may be substantial evidence which would prevent the direction of a verdict."

The above language was quoted with approval by this Court, sitting *en banc* in *Southern Pac. Co. v. Guthrie*, 186 F.2d 926, 932 (C.A. 9), cert. den. 341 U.S. 904, 71 S. Ct. 614, 95 L. Ed. 1343.

Thus, the distinction drawn in the cases, and even by plaintiff's motion, between "weight of the evidence" and "clear weight of the evidence" was clearly recognized by Judge Kilkenney in exercising his discretion to deny the alternative new trial motion (see *Union Pacific Railroad Co. v. Jarrett*, 381 F.2d 597, 601 (C.A. 9)).

In the absence of legal error, this Court has no basis for reviewing Judge Kilkenney's exercise of discretion denying plaintiff a new trial. The cases are collected in 6A *Moore's Federal Practice* (2d Ed.) p. 3820, § 59.08 where the rule is stated:

"What review, if any, may be had of the trial court's grant or denial of a motion for new trial on the ground that the verdict is against the weight of the evidence? None, as a general proposition; and this is in keeping with the usual principles that new trial rulings are, subject to certain narrow exceptions, non-reviewable. The motion for a new trial on the ground that the verdict is against the weight of the evidence is addressed to the sound discretion of the trial court. Unless the motion is not timely so that it has no power to act thereon, the trial court must exer-

cise its discretion; and hence a failure so to do is reviewable. Accordingly, the grant or denial of the motion under the compulsion of a mistake of law is reviewable. But assuming that the court has the power to consider the motion and does exercise its discretion its error in granting or denying the motion, if any, is usually one of fact and non-reviewable. Under unusual or special circumstances the trial court's action may constitute an abuse of discretion and be reviewable; but rarely can this be shown.

Plaintiff has cited six cases involving special and unusual circumstances where courts of appeal have reversed and ordered new trials. None are applicable here. In *U. S. v. Simmons*, 346 F.2d 313 (C.A. 5), the new trial was granted because of insufficient evidence to support the jury's finding that a tax refund claim was valueless, although there was a triable issue of fact as to value. In *Georgia Pacific Corp. v. U. S.*, 264 F.2d 161 (C.A. 5), the Court of Appeals in a tax refund suit held that the evidence required judgment for plaintiff as a matter of law. Unfortunately, plaintiff had not moved for a directed verdict, so a new trial was awarded to the taxpayer. In *Charles v. Norfolk & Western Ry. Co.*, 188 F.2d 691 (C.A. 7), cert. den. 342 U.S. 831, 72 S. Ct. 55, 96 L. Ed. 628, the Court of Appeals found that a basic instruction to which plaintiff had objected was "misleading and confusing," so that the case was outside the ordinary rule that an order granting or denying a new trial pursuant to an exercise of the trial court's discretion was not subject to review. *Sulzbacher v. Con-*

tinental Casualty Co., 88 F.2d 122 (C.A. 8), involved a vital decision of the same court which was not called to the trial court's attention until after a new trial motion was filed. On appeal, the Court of Appeals held that the trial court had abused its discretion in not granting a new trial because of the recent decision. *Magee v. General Motors Corp.*, 213 F.2d 899 (C.A. 3) involved motions for judgment n.o.v., or for a new trial, where it was conceded that neither the judge who tried the case (and later died), or the judge subsequently assigned, ever passed upon the motion for a new trial, which the Court of Appeals stated it would be the trial court's duty to allow where the verdict was "against the overwhelming weight of the evidence." Finally, in *Paine v. St. Paul Union Stockyards Co.*, 35 F.2d 624 (C.A. 8), the trial court had denied a motion to reopen the testimony because of claimed lack of power to do so. The appellate court held that the trial court's decision was based upon an erroneous conception of lack of power.

It is clear that the trial court's disposition of plaintiff's alternative motion for a new trial raises no question of law for review by this Court. This is the usual case where the trial court has correctly refused to substitute its judgment as to the facts and the credibility of the witnesses for that of the jury. To paraphrase this Court: "In this instance the judge, familiar with the atmosphere of the trial and sensible of imponderables that might prejudicially affect the action of the jury, was satisfied that their verdict was motivated by the evidence alone and that it was

not . . ." against the clear weight of the evidence or that it would result in a serious miscarriage of justice (see: *Bradley Mining Co. v. Boice*, 194 F.2d 80, 83 (C.A. 9), cert. den. 343 U.S. 941, 72 S. Ct. 1033, 96 L. Ed. 1347, and subsequent proceedings, 198 F.2d 790, 205 F.2d 937).

CONCLUSION

The judgment entered upon the general and special verdicts of the jury should be affirmed, with costs to defendant.

Respectfully submitted,

CLEVELAND C. CORY
CLARENCE R. WICKS
DON H. MARMADUKE
Attorneys for Appellee

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for a directed verdict, and in failing to enter judgment for defendant, on the ground that under Philippine law “. . . if the undertaking had any validity as to this defendant his liability, if any, upon the undertaking was discharged when plaintiff granted to Big Chrome an extension of time for the payment of its indebtedness without the consent of the defendant. . .” (Tr. p. 312).

STATEMENT OF THE CASE

The defense that any liability of defendant on the undertaking had been extinguished by extensions of time for payment granted by plaintiff to Big Chrome, without defendant's consent, was, in effect, eliminated from the case by the trial court's ruling on the day prior to trial that under the terms of the instrument itself, “. . . plaintiff had the right to extend the time of payment of the obligation without notice” (R. pp. 7-8).

At the trial, plaintiff's counsel introduced into evidence an exchange of correspondence between plaintiff and Big Chrome during the period from October 2, 1964 to January 24, 1966 relating to the extensions of time for payment; (Plf's. Exs. 17-A to 17-U, Tr. p. 104) and questioned plaintiff's resident counsel as to their contents (Tr. pp. 104-111). The witness was further cross-examined on this subject (Tr. pp. 116-123).

The trial court reserved decision on defendant's

motion for a directed verdict (Tr. p. 312). After judgment, one ground of defendant's opposition to plaintiff's motion for judgment n.o.v. was that his motion for a directed verdict should have been allowed because of the extensions of time given by plaintiff to Big Chrome, without defendant's consent (R. pp. 76-79).

In its order of March 14, 1968 denying both plaintiff's and defendant's motions for judgment, the trial court stated that the evidence showed without question that extensions of time within which to pay the indebtedness were granted by plaintiff to Big Chrome without defendant's consent; the court then stated (R. pp. 86-87):

"A reappraisal of the defendant's position in the light of the evidence of the case, forces a conclusion that my decision of January 10, 1968, upholding plaintiff's contention is on rather tenuous ground. On trial, the experts on Philippines law were in agreement that even though the guarantor's liability was solidary, direct and immediate, that liability would be extinguished, if time for payment was extended without the guarantor's consent. I am not at all certain that the language of the undertaking on which I previously relied to a large extent applies to a 'release,' as a matter of law, rather than a voluntary 'release.' It is now forcibly argued that a voluntary release is to be distinguished from a situation where the liability is extinguished due to a failure to obtain the guarantor's consent to an extension of time, and that such a release is involuntary and occurs by operation of law. Moreover,

I am now impressed with the argument that the particular provision was inserted to make it clear that the right of division—that is, the right to divide the amount of indebtedness among the guarantors—did not exist. By this language, the bank was making it clear that it was not obligated to give a release until the principal, or the guarantor, paid the indebtedness in full. My confidence in my previous memorandum is considerably shaken when I apply *Radio Corp. of The Philippines v. Roa*, 62 Phil. 211, to the facts as produced in evidence.

Certainly, this legal issue is not without its difficulties. If it was the only issue involved, I might well reverse my hasty decision on the eve of the trial and accept the defendant's views. Here, again, I shall leave the ultimate decision to higher authority and deny defendant's pending motion."

STATEMENT OF THE FACTS

In the pretrial order, the parties agreed that one of plaintiff's conditions, to which Big Chrome agreed on or about August 8, 1963, was that the indebtedness evidenced by the letter of credit would be: "5. Payable in three (3) years with semi-annual payments—failure to pay any one installment makes the account due and payable in full." (Ex. 5, R. p. 12).

It was also stipulated that on or about August 8, 1963 plaintiff forwarded its letter of credit to its San Francisco correspondent bank, with the total

amount of \$269,435.70 to be disbursed on the drafts of Discal Corporation in stated semi-annual installments commencing six months after complete shipment of the mining machinery. The date of complete shipment was on or about November 16, 1963 when the mining machinery was loaded on board a vessel at Portland, Oregon. Thus, Discal's first draft was presented to the San Francisco correspondent bank on May 16, 1964. Following payment, it was forwarded to plaintiff which received it on May 27, 1964 (Ex. 12). Plaintiff, in turn, sent its statement to Big Chrome on May 29, 1964 (Ex. 13). Under banking practice in the Philippines, the statement became past due 30 days later, on June 28, 1964 (Tr. pp. 72-73).

Some of the correspondence between plaintiff and Big Chrome between October 2, 1964 and January 24, 1966 (Ex. 17(a)-(u)) is referred to in plaintiff's brief (App. Br. pp. 28-30). In seven instances, particularly on October 2, 1964, October 19, 1964, November 16, 1964, February 24, 1965, March 18, 1965, May 7, 1965 and June 16, 1965 (Ex. 17(a), (c), (e), (i), (k), (m) and (o)), plaintiff extended additional time to Big Chrome to make the required payments. Most of the letters were signed by plaintiff's resident attorney who sent copies to plaintiff's president and vice president. The letter of November 16, 1964 extending time for payment until December 15, 1964 was signed by plaintiff's president (Ex. 17(e)).

Plaintiff did not offer proof that defendant con-

sented to any of the extensions. In fact, Putnam categorically denied giving consent at any time (Tr. p. 176).

SUMMARY OF ARGUMENT

Under the Philippine Civil Code applicable, an extension of time granted to the debtor by the creditor without the consent of the guarantor extinguishes the guaranty.

The undisputed facts show that the entire indebtedness became due after Big Chrome's failure to pay the first installment by June 28, 1964. Thereafter, plaintiff granted to Big Chrome numerous extensions of time to pay up to June 30, 1965. Since the Undertaking itself did not contain a "built-in" consent by defendant to such extensions, and since plaintiff did not expressly procure defendant's consent, the guaranty was thereby extinguished as a matter of Philippine law.

ARGUMENT

I

**The Trial Court Erred in Not Granting Defendant's Motion
for a Directed Verdict on the Ground that the
Guaranty was Extinguished by the Extensions
of Time Given by Plaintiff to Big Chrome
Without Defendant's Consent.**

A. The Undertaking cannot be construed as giving plaintiff a right to extend time of payment to Big Chrome without defendant's consent.

1. The Trial Court's Rulings

The trial court in its pretrial ruling (R. pp. 10-11) concluded that certain language employed in the Undertaking impelled the conclusion that plaintiff was given the right to extend the time of payment of the obligation without the guarantor's consent. The court quoted the language ". . . the liability on this guaranty shall be solidary, direct and immediate . . ." (R. p. 7).

However, at the trial, the Philippine attorneys who testified both agreed that even though the guarantor's liability is solidary, direct and immediate, his liability will be extinguished if time for payment is extended without his consent. This testimony was adopted by the trial court in its post-trial order discussing defendant's motion for a directed verdict, and in the court's conclusion that its previous decision was "on rather tenuous ground" (R. p. 86).

In this post-trial opinion, the trial court also drew back from its original position that the release clause at the end of the document constituted a "built-in" consent to extensions of time. That clause provided that the guarantor shall be released from its liability under this guaranty only after the principal or the guarantor had fully satisfied or paid its obligations with the bank.

Again, Ozaeta, defendant's expert on Philippine law, stated his opinion as to the necessity for such a provision and that it could not be construed as a waiver of the right to be released in the event of an extension (Tr. pp. 228-229).

Following the introduction of this expert testimony the trial court stated (R. pp. 86-87):

"... I am not at all certain that the language of the undertaking on which I previously relied to a large extent applies to a 'release,' as a matter of law, rather than a voluntary 'release.' It is now forcibly argued that a voluntary release is to be distinguished from a situation where the liability is extinguished due to a failure to obtain the guarantor's consent to an extension of time, and that such a release is involuntary and occurs by operation of law. Moreover, I am now impressed with the argument that the particular provision was inserted to make it clear that the right of division—that is, the right to divide the amount of indebtedness among the guarantors—did not exist. By this language, the bank was making it clear that it was not obligated to give a release until the principal, or the guarantor, paid the indebtedness in full. . . ."

The trial court's opinion in this respect is strengthened by Ozaeta's testimony that if the parties intended to grant the bank the right to extend the principal obligor's time to pay without releasing the guarantor, it would have been perfectly easy to employ simple language to that effect. In the absence of express language, Ozaeta relied upon the provision of Article 2055 of the Civil Code of the Philippines [formerly Article 1827] which states in part: "A guaranty is not presumed; it must be express and cannot extend to more than is stipulated therein." (Tr. pp. 235-237).

In *La Insular v. Machuca Go-Tauco and Nubla Co-Siong*, 39 Phil. 567, the Philippine Supreme Court said:

"It is undoubtedly true that the law looks upon the contract of suretyship with a jealous eye, and the rule is settled that the obligation of the surety cannot be extended by implication beyond its specified limits. Article 1827 of the Civil Code so declares (*Uy Aloc vs. Cho Jan Ling*, 27 Phil. Rep. 427); and with this doctrine the common law is accordant. As was said by Justice Story in *Miller vs. Stewart* (9 Wheat., 680; 6 L. ed., 189):

" 'Nothing can be clearer, both upon principle and authority, than the doctrine that the liability of a surety is not to be extended, by implication, beyond the terms of his contract. To the extent, and in the manner, and under the circumstances pointed out in his obligation, he is bound, and no farther.' "

In the later case of *Solon v. Solon*, 64 Phil. 729, the Philippine Supreme Court made the following comment:

“ . . . The clauses of a contract of suretyship determine the extent of the liability of the surety (Government of the Philippine Islands vs. Herrero, 38 Phil. 410), it not being proper to extend its effects farther than the clear terms of the contract by mere implications. A surety should be liable only in the manner and to the extent, and under the circumstances pointed out in the contract of suretyship or which may be clearly deduced therefrom (*La Insular vs. Machuca Go-Tauco and Nubla Co-Siong*, 39 Phil. 567).”

B. The undisputed facts and the applicable Philippine law compel the conclusion that defendant's liability to plaintiff upon the undertaking was extinguished by plaintiff's extensions of time to Big Chrome for the payment of its indebtedness, without defendant's consent.

As above noted, under condition 5 contained in plaintiff's letter to Big Chrome, dated August 7, 1963 (Ex. 5), to which Big Chrome consented (R. p. 12), the failure to pay any one installment made the account due and payable in full. Thus, at all times after June 28, 1964 plaintiff had a right to sue Big Chrome for the full amount of the letter of credit. Furthermore, the letters introduced by plaintiff established that plaintiff expressly granted to Big Chrome extensions of time up to June 30, 1965 within which to pay its indebtedness (Exs. 17(a), 17(c), 17(e),

17(i), 17(k), 17(m), 17(o)). It was also undisputed that defendant did not consent to any of the time extensions.

The leading decision of the Supreme Court of the Philippines on almost identical facts is *Radio Corporation of the Philippines v. Roa*, 62 Phil. 211, which Philippine counsel and the trial court recognized as binding authority (Tr. p. 237, 284, R. p. 87) in construing Article 2079 of the Civil Code (formerly Article 185) which provides in part: "An extension granted to the debtor by the creditor without the consent of the guarantor extinguishes the guaranty."

In the *Radio Corporation* case, it was held that a written express extension of time for the payment of an installment without the consent of the guarantor constituted an extension of time of the whole amount of the indebtedness and therefore discharged the guarantors. The contention that an extension had been granted was based upon a letter which read as follows:

"Mr. Jesus R. Roa
Cagayan, Oriental Misamis

"Attention of Mrs. Ampara Chavez de Roa

"Dear Sir: We acknowledge with thanks the receipt of your letter of March 9th together with your remittance of P200 for which we enclose receipt No. 7558. We are applying this amount to the balance of your January installment.

"We have no objection to the extension requested by you to pay the February installment

by the first week of April. We would, however, urge you to make every efforts to bring the account up-to-date as we are given very little discretion by the RCP in giving extension of payment.

“Very truly yours,

“RADIO CORP OF THE PHIL.

“By: ERLANGER & GALINGER, INC.

(Sgd.) “H. N. SALET

“Vice-President”

The contract which was the basis of Mr. Roa's indebtedness contained this language:

“In case the vendee-mortgagor fails to make any of the payments as hereinbefore provided, the whole amount remaining unpaid under this mortgage shall immediately become due and payable and this mortgage on the property herein mentioned as well as the Luzon Surety Bond may be foreclosed by the vendor-mortgagee; . . .”

The Philippine court held (62 Phil. at pp. 216-218):

“The stipulation in the contract under consideration, copied above, is to the effect that upon failure to pay any instalment when due the other instalments *ipso facto* become due and payable. In view of the fact that under the express provision of the contract, quoted above, the whole unpaid balance automatically becomes due and payable upon failure to pay one installment, the act of the plaintiff in extending the payment of the instalment corresponding to February, 1932, to April, 1932, without the consent of the guaran-

tors, constituted in fact an extension of the payment of the whole amount of the indebtedness, as by that extension the plaintiff could not have filed an action for the collection of the whole amount until after April, 1932. Therefore appellants' contention that after default of the payment of one instalment the act of the herein creditor in extending the time of payment discharges them as guarantors in conformity with articles 1851 and 1852 of the Civil Code [old] is correct.

“It is a familiar rule that if a creditor, by positive contract with the principal debtor, and without the consent of the surety, extends the time of payment, he thereby discharges the surety. . . . The time of payment may be quite as important a consideration to the surety as the amount he has promised conditionally to pay. . . . Again, a surety has the right, on payment of the debt, to be subrogated to all the rights of the creditor, and to proceed at once to collect it from the principal; but if the creditor has tied his own hands from proceeding promptly, by extending the time of collection, the hands of the surety will equally be bound; and before they are loosed, by the expiration of the extended credit, the principal debtor may have become insolvent and the right of subrogation rendered worthless. It should be observed, however, that it is really unimportant whether the extension given has actually proved prejudicial to the surety or not. The rule stated is quite independent of the event, and the fact that the principal is insolvent or that the extension granted promised to be beneficial to the surety would give no right to the creditor

to change the terms of the contract without the knowledge or consent of the surety. Nor does it matter for how short a period the time of payment may be extended. The principle is the same whether the time is long or short. The creditor must be in such a situation that when the surety comes to be substituted in his place by paying the debt, he may have an immediate right of action against the principal. The suspension of the right to sue for a month, or even a day, is as effectual to release the surety as a year or two years.' (21 R.C.L., 1018-1020.)."

Finally, the Philippine court overruled the contention that there was no consideration for the extension granted the principal debtor (62 Phil. at p. 218):

"Plaintiff-appellee contends that there was no consideration for the extension granted the principal debtor. Article 1277 of the Civil Code provides that 'even though the consideration should not be expressed in the contract, it shall be presumed that a consideration exists and that it is licit, unless the debtor proves the contrary.' It was incumbent upon the plaintiff to prove that there was no valid consideration for the extension granted."

CONCLUSION

It is axiomatic that the successful party in the district court may sustain its judgment on any ground that finds support in the record (*Jaffke v. Dunham*, 352 U.S. 280, 77 S. Ct. 267, 1 L. Ed. 2d 314; followed in *Dessar v. Bank of America*, 353 F.2d 468

(C.A. 9) and *M.O.S. v. John I. Haas Co., Inc.*, 375 F.2d 614 (C.A. 9)).

The trial court erred in refusing to direct a verdict for defendant at the close of the evidence, on the ground that the undisputed evidence showed that any claimed liability of defendant on the undertaking was extinguished by plaintiff's extensions of time to Big Chrome for payment of its indebtedness, without defendant's consent.

Therefore, assuming, for purposes of argument only, that plaintiff's appeal has merit, nevertheless, the final judgment of dismissal should be affirmed, with costs to defendant.

Respectfully submitted,

CLEVELAND C. CORY
CLARENCE R. WICKS
DON H. MARMADUKE
Attorneys for Appellee
and Cross-Appellant



No. 23018

FEB 21 1958

United States
COURT OF APPEALS
for the Ninth Circuit

RIZAL COMMERCIAL BANKING CORPORATION,
a corporation

Appellant,

v.

NED PUTNAM,

Appellee.

APPELLANT'S REPLY BRIEF AND ANSWERING BRIEF
UPON CROSS-APPEAL

Appeal from the United States District Court
for the District of Oregon

HONORABLE JOHN F. KILKENNY, Judge

LINDSAY, NAHSTOLL, HART, DAFOE & KRAUSE
ALLAN HART

9th Floor Loyalty Building
Portland, Oregon 97204

Attorneys for Appellant

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W.M. B. LUCK

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No. 23018

United States
COURT OF APPEALS
for the Ninth Circuit

RIZAL COMMERCIAL BANKING CORPORATION,
a corporation

Appellant,

v.

NED PUTNAM,

Appellee.

**APPELLANT'S REPLY BRIEF AND ANSWERING BRIEF
UPON CROSS-APPEAL**

*Appeal from the United States District Court
for the District of Oregon*

HONORABLE JOHN F. KILKENNY, Judge

APPELLANT'S REPLY BRIEF

The questions presented are as stated in appellant's opening brief and in defendant's answering brief. We reply to defendant's brief as follows:

I. The Trial Court Erred in Not Granting Plaintiff's Motion for a Directed Verdict and in Denying Plaintiff's Subsequent Motion to Set Aside the Verdict and Judgment for Defendant and Enter a Verdict and Judgment in Plaintiff's Favor for \$231,142.77.

A. Defendant's execution of the Undertaking was supported by cause, or by consideration, or by both.

The parties are in agreement (see Appellee's Br. p. 11) that the trial court correctly defined "cause" under Philippines law, that is, "any reason of substance which may induce the execution of an agreement can be the cause of the agreement" (Tr. p. 329). This definition is supported by *General Enterprises, Inc. v. Lianga Bay Logging Co.*, cited and discussed at page 45 of Appellant's Opening Brief. Thus the jury's finding that there was no cause for defendant's execution of the Undertaking cannot stand if, viewing the evidence and inferences favorably to defendant, the record nevertheless shows that defendant had a reason for executing the Undertaking, and that his reason was "of substance."

Even assuming that on December 13, 1967 Putnam did not know that the instrument he was signing was a guaranty, and thought that it was merely something that would enable Big Chrome to get the mining machinery through customs (Tr. pp. 163, 165), still *it was essential for the Big Chrome venture to get the mining machinery through customs*. The entire venture would collapse if Big Chrome could not get possession of the mining machinery.

Putnam's admitted desire to help get the mining machinery through customs, and thus to save the Big Chrome venture, was not merely a "personal motive," as suggested in defendant's brief (Appellee's Br. p. 14). It was a directly relevant *business* reason, and it was of urgent gravity. Putnam stood to lose his \$48,000 investment in Big Chrome, to say nothing of his interest in Big Chrome's hoped-for profits, and perhaps would be forced to refund the \$100,000 he had already received for his portion of the mining machinery, if he had refused to sign the instrument that was tendered to him for signature at the Bank on December 13, 1963.

Thus the undisputed evidence conclusively established cause for Putnam's execution of the Undertaking, even on the assumption that he signed it as a customs-release document. But as contended in appellant's opening brief (p. 47), the issues of cause or consideration should be examined on the assumption that the Undertaking was otherwise a valid agreement, that is, on the assumption that Putnam signed it on December 13, 1963 knowing that it was a guaranty. Only in this way can the issues of cause or consideration be analyzed separately from the issue of mistake.

If on December 13, 1963 Putnam was asked to sign as a guarantor of Big Chrome's liability under the Letter of Credit, and knowingly agreed to do so, the uncontrovertible cause for his execution of the Undertaking was, again, that this would enable Big

Chrome to get possession of the shipping documents and thus to get the mining machinery through customs and on up to the mine site. In view of his major involvement in the Big Chrome venture, and his stake in its ultimate success, this was clearly "a reason of substance" sufficient to induce him to become a guarantor of Big Chrome. Indeed at that point Putnam could not afford to jeopardize the venture by refusing to become a guarantor.

Defendant's only answer to this is a somewhat obscure contention that plaintiff Bank "acted wrongfully in conditioning the release of the documents upon the execution of the trust receipt" (Appellee's Br. p. 17). In advancing this contention, defendant concedes that the Bank was entitled to require execution of a chattel mortgage before releasing the shipping documents to Big Chrome; but defendant argues that the Bank could not substitute a trust receipt as an interim security instrument (Appellee's Br. pp. 16-17).

This ignores the fact that the trust receipt was *less* of a burden on Big Chrome than a chattel mortgage would have been, in that the trust receipt was not recordable and so did not subject the mining machinery to a lien valid against Big Chrome's other creditors. The parties' respective expert witnesses on Philippines law agreed on this (Tr. pp. 242, 275). Thus the Bank was doing Big Chrome a favor, rather than the opposite, in agreeing to release the shipping documents on a trust receipt.

Since the Bank's admitted right to demand a chattel mortgage included the lesser right to be lenient and accept a trust receipt, defendant's brief impliedly acknowledges that the Bank's promise to release the shipping documents on a trust receipt constituted cause for Putnam's execution of the Undertaking.

With respect to the issue of consideration, defendant's brief ignores Article 2048 of the Philippines Civil Code (Appellant's Opening Br., Appendix B, p. 6), which provides that a "guarantee is gratuitous, unless there is a stipulation to the contrary." There is no "stipulation to the contrary" in the Undertaking in this case, unless it can be said that the recital of consideration therein is such a stipulation. But this recital of consideration expressly includes "letters of credit . . . that *have been* . . . granted" to Big Chrome, thus clearly including the Letter of Credit previously issued to Big Chrome. It follows that under Article 2048, consideration for the Undertaking either was unnecessary, or was supplied by the Bank's issuance of the Letter of Credit to Big Chrome on August 8, 1963.

In appellant's opening brief (p. 53), we contended that *Bank of the Philippines v. Foerster*, 49 Phil. 843, establishes that under Philippines law a guaranty of a prior extension of credit is valid and enforceable, without other consideration being shown, where it is clear that the parties so intended. Defendant's attempted distinction of the *Foerster* case (Appellee's Br. pp. 15-16) is not valid. Even though Putnam was not an

officer of Big Chrome, he had a contractual responsibility for its financial affairs; and even if for present purposes we accept his testimony that he was not a party to the arrangements for the previous issuance of the Letter of Credit to Big Chrome, he admittedly had agreed to obtain a letter of credit. And if we again analyze the consideration issue separately from the mistake issue, Putnam's execution of the Undertaking, knowing and intending it as a guaranty, clearly was intended as a guaranty of Big Chrome's liability under the previously issued Letter of Credit. Thus the facts here are closely similar to those in *Foerster*.

Accordingly, we renew our contention that, even viewing the evidence and inferences favorably to defendant, the record conclusively establishes that there was cause, or consideration, or both, for Putnam's execution of the Undertaking. The jury's findings that the Undertaking was without cause or consideration are not supported by any substantial evidence and should be set aside.

B. Defendant is bound by the Undertaking, even if he signed it without knowing its contents, because of his own negligence.

We are puzzled by defendant's argument (Appellee's Br. pp. 17-19) that the question of defendant's negligence is not properly before this Court. On the mistake issue, plaintiff's motion for a directed verdict was on the ground that a contracting party "who signs without reading thereby takes the burden of the obli-

gation.” This statement did not use the word “negligence,” but by necessary legal implication it was predicated on negligence. That is, one who elects to sign a contract without reading it is bound by it, even though he didn’t know its terms, for only one reason: because he was negligent, and his negligence caused his ignorance of the contract’s terms. If such a contracting party was *not* negligent—if, for example, his ignorance of the contract’s terms was due to fraud or deceit by the other contracting party—he almost certainly will not be bound. Thus it is only when a contracting party was negligent, and *because* he was negligent, in signing a contract without reading it, that he “takes the burden of the obligation.”

Plaintiff’s contention in support of its motion for a directed verdict on this issue was logically and legally equivalent to a contention that defendant was negligent when he deliberately elected not to read the Undertaking before signing it, and *because of his negligence* must take the burden imposed by the Undertaking, even if he didn’t know its contents. This was the view of the trial court (Tr. p. 339).

The crux of defendant’s argument on the issue of mistake (see pages 20-22 of Appellee’s Br.) is that the jury “could have reasonably found,” among other things, that when Putnam arrived at the Bank on December 13, 1963 to sign some papers:

“he reasonably understood that the papers had to be signed to permit Big Chrome to obtain the necessary Customs clearance and tax exception for the goods. No one told him that the docu-

ment being signed was a guaranty or undertaking . . . He did not read the document, *but this was excusable in view of the confidence which he placed in Wayne Fogelstrom. . .*" (Italics added)

Thus the defendant is arguing that although Putnam admittedly held the instrument in his own hands, observed that it was entitled "Undertaking," read its first portion and had time to read all of it if he had wanted to, and although Putnam admitted that he signed without reading all of the instrument because he "had the nerve to," nevertheless the jury could find that Putnam was not negligent *because of his confidence in Fogelstrom.*

This is an extraordinary contention. If this is the law, a loan applicant can come into a bank with an associate to apply jointly for a loan, sign the loan documents without reading them, relying on his co-signer's assurance that it is all right to do so, and thus escape liability for repayment of the loan.

Many bank loan forms are much longer and more complicated than was the Undertaking in this case, and it may be that many borrowers sign such forms without reading them, frequently on the advice of associates in whom they have confidence; but we know of no cases, Philippine or American, excusing such borrowers from liability on this account.

Defendant's above contention should be summarily rejected.

As a further answer on the issue of mistake, de-

fendant quotes two paragraphs from the trial court's opinion (R. pp. 84-85), wherein the court sought to distinguish between Putnam's claim that he did not know what kind of an instrument he was signing, and the claim sometimes made in other cases that a contracting party knew the nature of the instrument he signed, but misunderstood its language (Appellee's Br. pp. 22-23).

But the trial court's distinction is without substance. In stating the rule said to be applicable, the court quoted from and relied on the following from Williston on Contracts, 3d Ed., Vol. 1, Section 95A:

" . . . If *without negligence* on his part, a signer attaches his signature to a paper assuming it to be a paper of a different character, the paper is void. Such a mistake as to the character of the instrument may relate to its existence as a contract or legally operative document of any kind, or to whether it is the kind of contract or legal document which it purports or is represented to be. . . ." (p. 351) (*Italics added*)

Both the trial court and defendant apparently disregarded the words "*without negligence*," which we have italicized in the above quotation. But these words cannot be disregarded. A contracting party who signs without knowing the nature of the instrument is nevertheless bound by it, if his ignorance is due to his own negligence.

Accordingly, we respectfully contend that Putnam's own testimony establishes that if Putnam signed the Undertaking without knowing that it was a guar-

anty, his mistake was due to his own negligence as a matter of law, and he is therefore liable on the Undertaking.

II. The Verdicts Are Against the Clear Weight of the Evidence, and the Trial Court Abused Its Discretion in Denying Plaintiff's Motion for a New Trial.

Defendant's argument on the issue of the trial court's abuse of discretion in denying plaintiff's motion for a new trial (Appellee's Br. pp. 26-32) erroneously assumes that the only basis for plaintiff's claim is the court's statement (R. p. 46) that "I personally feel that the weight of the evidence is in favor of plaintiff's contentions." But the trial court, having made this statement, then went on to say:

"I do not feel that anything would be gained by granting a new trial. The Court would still be faced with the same legal issues as were raised on the pending motions and in the former trial. Sooner or later, these problems must be presented to the Court of Appeals. *To grant a new trial would only postpone the ultimate conclusions of the Court of Appeals.*" (R. p. 46; Appellant's Opening Br. Appendix C, p. 12. Italics added.)

Thus the trial court, after finding that the weight of the evidence was in plaintiff's favor, denied plaintiff's motion for a new trial in order to avoid postponing this Court's rulings on the legal issues. Defendant's brief overlooks this crucial point.

The Court's denial of plaintiff's motion for a new trial was an abuse of discretion not merely because

the Court had concluded that the weight of the evidence was in plaintiff's favor, but also because the denial was on a legally untenable ground.

As we contended in appellant's opening brief (p. 69), the fact that a new trial would delay appellate review of disputed legal questions is not a valid ground for denying a new trial that is otherwise legally justified. *A new trial will always delay appellate review of disputed legal questions.* If this were a valid reason for denying a motion for a new trial, there would be few cases in which a new trial could be allowed.

Since defendant's brief does not challenge our contention that the verdicts are against the clear weight of the evidence, this issue should be resolved in plaintiff's favor.

Accordingly, plaintiff renews its prayers as set forth on page 79 of its opening brief.

**APPELLANT'S ANSWERING BRIEF ON
APPELLEE'S CROSS-APPEAL**

The issues presented on appellee's cross-appeal are (1) whether the Undertaking contained Putnam's advance consent, agreeing that the Rizal Bank could grant Big Chrome extensions of time for paying the amounts due under the Letter of Credit, and (2) whether, as claimed by appellee, the undisputed facts show that the Bank granted extensions of time to Big Chrome.

STATEMENT OF THE CASE

Prior to the opening of the trial the Court construed the Undertaking as containing Putnam's consent to granting Big Chrome extensions of time for payment. As we will show, the Court's later doubts on this question are groundless.

Upon Big Chrome's initial default on June 29, 1964, the Rizal Bank's loan department forwarded the Big Chrome file to its legal department for further handling (Tr. pp. 73, 74). In a series of letters to Big Chrome, most of which were written by the Bank's resident attorney, Rudolpho Pineda, the Bank demanded payment of the amount due, and threatened legal proceedings if prompt payment was not made. In its answering letters Big Chrome repeatedly asked that such proceedings be delayed because of Big Chrome's continuing efforts to refinance. The

Bank acceded to these requests until early in 1966, when it turned the file over to Alberto Meer, its Manila counsel, with instructions to proceed with litigation (Tr. p. 31).

The letters making up the above correspondence are in evidence in this case as Exhibits 17a through 17u. We reviewed them in appellant's opening brief (pp. 28-31).

In defendant's "Statement of the Facts" on this issue, the claim is made that in the above correspondence the Bank "extended additional time to Big Chrome to make the required payments" (Appellee's Br. p. 37). This is not correct. While several of the letters spoke loosely about additional time for paying the amount due, it is clear from the general tenor of the correspondence that Big Chrome was asking for postponements of the Bank's threatened litigation, and the Bank was setting deadlines after which it would proceed with litigation.

QUESTIONS PRESENTED

On this cross-appeal the questions presented are as follows:

1. Does the Undertaking contain Putnam's consent allowing the Bank to grant Big Chrome extensions of time?
2. Is it so clear as to be beyond dispute that the Bank in its correspondence with Big Chrome (Ex. 17a through 17u) granted Big Chrome ex-

tensions of the time for payment, so that defendant was entitled to a directed verdict on this issue?

ARGUMENT

I. The Undertaking Contained Putnam's Consent Allowing the Bank to Grant Big Chrome Extensions of Time.

On this question several provisions of the Undertaking (Ex. 10; Appellant's Opening Br., Appendix A) must be examined.

The second paragraph of the instrument contains the following language:

"The undersigned expressly . . . agrees that the securities of every kind, that are now and may hereafter be left with the RIZAL COMMERCIAL BANKING CORPORATION, its successors, indorseees or assigns as collateral to any evidence of debt or obligations or upon which a lien may exist thereto, may be withdrawn or surrendered at any time, *and the time of payment thereof extended*, without notice to, or consent by the undersigned" (Italics added.)

Appellee contended in the court below that the antecedent of "thereof" in the clause "and the time of payment *thereof* extended" is the phrase "the securities of every kind," so that this clause was a consent allowing the Bank to extend the time of payment of any securities left with it as collateral. This contention may have some merit in terms of the parsing of the quoted sentence; but it doesn't make any sense at all in the context of this banking transaction, or indeed of most similar banking transactions.

We contend, on the contrary, that the antecedent of "thereof" in the above clause is "evidences of debt or obligations." That is, we read this provision as an agreement that securities held as collateral for evidences of debt or obligations may be withdrawn or surrendered, and that the time of payment of the evidences of debt or obligations may be extended, without notice to or consent of the undersigned. As thus read, the clause "and the time of payment *thereof* extended" has a practical meaning and effect.

In support of this, we point out that securities held by a bank as collateral are not normally paid to it. And if in a rare case a bank is offered a security as collateral that will mature while being held, any prospect that at its maturity the issuer may have to ask for an extension of the time for payment would probably persuade the bank that the security was of dubious value as collateral, and the bank would probably demand that the borrower supply substitute collateral. In short, we can conceive of no circumstances in which a bank would foresee that it would routinely want to grant time extensions to the issuers of securities held as collateral.

And in any event, granting an extension of the time for paying a security held by a bank as collateral for a loan would not extinguish the liability of a guarantor of the loan. Under Article 2079 of the Civil Code of the Philippines (Appellant's Opening Br., Appendix B, p. 6), it is an extension granted to the *debtor* without a guarantor's consent that extin-

guishes the guaranty. Thus an advance consent from a guarantor allowing the bank to grant extensions of time to the issuers of securities held as collateral would be meaningless.

We submit, therefore, that the clause "and the time of payment thereof extended" in the Undertaking in this case should be construed as Putnam's consent allowing the Bank to extend Big Chrome's payment times.

It may be noted that the plaintiff's expert witness on Philippines law, Alberto Meer, testified that in his opinion the quoted clause should be so construed (Tr. p. 266).

The next clause in the same paragraph of the Undertaking, wherein it is agreed that the liability on the guarantee is to be "solidary, direct and immediate" denies to the guarantor the right of "excussion" under the Civil Code, that is, the right to require that the principal debtor's assets be exhausted before recourse is sought under the guaranty. This is not in issue here.

The last clause in this paragraph of the Undertaking reads as follows:

"and the undersigned will at any time on demand pay to the RIZAL COMMERCIAL BANKING CORPORATION the above-mentioned obligation of the principal."

While this clause does not deal directly with the effect of time extensions on the guarantor's liability, it

reiterates and strengthens the overall purpose of the instrument, that that liability is to be absolute and unqualified. The promise in this clause is that after the principal obligation becomes due, the guarantor will pay it "*at any time on demand.*"

The next paragraph of the Undertaking is of direct importance here. It reads as follows:

"The herein undersigned shall be released from its liability under this guaranty only after the principal or said undersigned has fully paid or satisfied its above-mentioned obligations with the RIZAL COMMERCIAL BANKING CORPORATION."

The plain meaning of this provision is that only one thing can release the guarantor from his liability: full payment of the debt by either the principal or the guarantor. As stated by Alberto Meer, plaintiff's expert witness, this provision "brushes aside all forms of extinguishment of the guarantee"; it "clinches the waivers indicated in the second paragraph, the usual waiver of notice of dishonor or protest, extension of payment, and the usual commercial forms of waiver that banks use in our jurisdiction" (Tr. p. 265).

In its Opinion and Order Denying Plaintiff's Motions for Judgment N.O.V., or for New Trial (R. p. 81; Appellant's Opening Br., Appendix C), the Trial Court for the first time expressed doubt about the correctness of this interpretation. The court's doubts were on two grounds, neither of which has merit.

In the first place, the court suggested that

“a voluntary release is to be distinguished from a situation where the liability is extinguished due to a failure to obtain the guarantor’s consent to an extension of time, and that such a release is involuntary and occurs by operation of law.” (Appellant’s Opening Br., Appendix C, p. 13).

Apparently the court meant by this that the provision in question applies only to a voluntary release, and is not applicable to an involuntary release by operation of law.

One wonders what kind of a “voluntary release” would be covered by the provision. Obviously it would have to be a voluntary release by the act of the Bank. Thus the court is suggesting that this provision is an agreement by Putnam that if the Bank voluntarily releases Big Chrome or him before the Bank is paid in full, Putnam shall nevertheless not be released until the Bank receives full payment. This is contradictory and confusing, and there is no basis for the court’s suggestion that this provision does not apply to involuntary releases by operation of law.

In the second place, the court said:

“Moreover, I am now impressed with the argument that the particular provision was inserted to make it clear that the right of division—that is, the right to divide the amount of the indebtedness among the guarantors—did not exist. By this language, the bank was making it clear that it was not obligated to give a release until the principal, or the guarantor, paid the indebtedness in full.” (Appendix C, p. 13)

The first objection to this is that the right of division does not exist if solidarity has been expressly stipulated (Civil Code, Art. 2065), as it was in the undertaking. Therefore this provision was wholly unnecessary as a denial of the right of division.

Apart from this, however, we can find nothing in the language of this provision that *limits* its effect to a denial of the right of division. The language in question is all-inclusive in its tenor and effect. The undersigned guarantor is to be released *only* after the principal or the guarantor has been paid in full.

Radio Corporation of the Philippines v. Roa, 62 Phil. 211 (1935), cited by the court in connection with its discussion of this provision, does not deal with such a provision, and in no way supports the court's construction thereof.

Accordingly we contend that the Undertaking taken as a whole clearly contains Putnam's advance consent, allowing the Bank to extend Big Chrome's times for payment.

II. The Bank's Correspondence with Big Chrome (Ex. 17a through 17u) Did Not Grant Big Chrome Extensions of the Times for Payment.

Article 2079 of the Civil Code (Appellant's Opening Br., Appendix B, p. 6) provides as follows:

"An extension granted to the debtor by the creditor without the consent of the guarantor extinguishes the guaranty. The mere failure on the part of the creditor to demand payment after

the debt has become due does not of itself constitute any extension of time referred to herein."

The Philippines case principally relied upon by defendant on this issue, *Radio Corporation of the Philippines v. Roa*, 62 Phil. 211 (1935), establishes that under Philippines law an extension of time granted to the debtor will not extinguish a guaranty unless it is contractual, that is, unless it is binding and enforceable against the debtor. In the *Radio Corporation* case the court said that it is when the creditor "by positive contract" extends the debtor's payment that the guarantor is discharged. 62 Phil. at 217. In another case the Philippines court said that for the guarantor to be discharged, the time extension "must of necessity be based on some new agreement between the creditor and principal debtor, by virtue of which the creditor deprives himself of his right to immediately bring an action for the enforcement of his claim." *Hongkong & Shanghai Banking Corporation v. Aldecoa & Co.*, 30 Phil. 255, 269 (1915).

The Bank's correspondence with Big Chrome in Exhibits 17a through 17u falls far short of showing a "positive contract" for a time extension.

Throughout this correspondence, the Bank was repeatedly threatening legal action against Big Chrome, and then, in response to Big Chrome's pleas for more time within which to complete its claimed refinancing, imposing a succession of deadlines for payment by Big Chrome if it would avoid litigation.

For example in Exhibit 17d, dated November 13, 1954, Big Chrome urged the Bank "to extend us your further consideration by not pressing us for the payment of your account at this time." In Exhibit 17e, dated November 16, 1964, the Bank answered that "we are giving in to your request for extension but only up to December 15, 1964." While this letter speaks of an "extension" and (in the next paragraph) of an "extension for payment," it is not a "positive contract," i.e., a novation, changing the due date of any payment. In the first place, Big Chrome had not requested that a due date be changed, but only that the Bank not press it at this time; and the Bank's answer was merely responsive to this request. In the second place, the Bank's letter cannot have been intended as a novation, changing the due date of an installment, because no installment is identified as being extended. Which installment is meant? Was it the first installment, which Big Chrome should have paid on May 29, 1964, and which became delinquent on June 29, 1964? If so, was the interest for the intervening months being forgiven? Or was it the second installment, which was not yet due, but which in fact became due about two weeks later?

In this connection we note defendant's argument (Appellee's Br. p. 42) that Big Chrome's default on the first installment triggered an automatic acceleration, making the entire account immediately due and payable in full. We agree that the Bank was entitled to such acceleration under the terms on which the Let-

ter of Credit was issued. But it elected not to demand acceleration. Pineda's letter of October 2, 1964 (Ex. 17a) threatened acceleration, but this threat was not carried out until 1966. The fact is that the Bank has not claimed and does not claim interest on the full face amount of the Letter of Credit (less the time deposit) since June 29, 1964, as it would have if the loan had been accelerated on that date.

In this respect the Bank's November 16, 1964 letter (Ex. 17e) should be compared with the letter which was held to be "a positive contract" in the *Radio Corporation* case. In the latter case, the debtor requested and the creditor agreed to a specified extension of a specified *future* installment.

Moreover, there was absolutely no consideration for the Bank's claimed extension in this case. In the *Radio Corporation* case the debtor at least made a new promise to pay the deferred installment on the extended date. In this case, however, Big Chrome promised nothing in return for the purported extension.

We strongly contend that the Bank's November 16, 1964 letter was not a novation, but only a designation of December 15, 1964 as the deadline before which Big Chrome must put its account in order if it would avoid foreclosure or other legal proceedings.

Substantially the same analysis is applicable to Big Chrome's letter dated February 15, 1965 (Ex. 17h) and the Bank's answer dated February 24, 1965 (Ex. 17i). In Exhibit 17h, Big Chrome said, "we would like to request your goodselves to bear with our

situation a little while longer and grant us enough time to finalize all these transactions." In Exhibit 17i, the Bank answered that

"considering your present predicament and the assurance that you will settle this matter to our satisfaction, we are giving you 30 days from date hereof to comply with it so that after the expiration of the above-mentioned period we shall feel free to seek court action in order to protect the interest of the Bank."

At this time both the first and second installments under the Letter of Credit were in default. The third installment would become due late in May 1965.

For the reasons stated above, we contend that the Bank's letter of February 24, 1965 (Ex. 17i) was not a novation, fixing a new date for any installment under the Letter of Credit, but was merely a statement of a new deadline after which the Bank would sue if the account was not then settled.

These comments also apply to the Bank's letters of March 10, 1965 (Ex. 17k), May 7, 1965 (Ex. 17m), and June 16, 1965 (Ex. 17o).

In support of our contention that the Bank's letters to Big Chrome discussed above did not constitute novations, extending the time of payment of any installment, we point out that in its demands for payment sent to Big Chrome and to the guarantors, and in its statements of the Big Chrome account throughout this litigation, the Bank has consistently computed interest from the original due dates for each install-

ment, rather than from any extended date; thus confirming that it did not intend to agree to any time extensions. And neither Big Chrome nor Putnam has ever claimed that the interest should have been computed from an extended date.

At the very least, the meaning and effect of the Bank's said letters was a vigorously disputed question for the jury. Defendant certainly was not entitled to a directed verdict on such a question.

CONCLUSION

For the reasons set forth above, the Undertaking should be construed as containing Putnam's advance consent, allowing the Bank to grant Big Chrome extensions of the time its payments were due; and in any event, defendant clearly was not entitled to a directed verdict on the ground that time extensions were granted to Big Chrome, extinguishing defendant's liability as a guarantor.

Respectfully submitted,

ALLAN HART
LINDSAY, NAHSTOLL, HART, DAFOE
& KRAUSE
Attorneys for Plaintiff-Appellant

No. 23018

**United States
COURT OF APPEALS**

for the Ninth Circuit

RIZAL COMMERCIAL BANKING
CORPORATION, a corporation,

Appellant,

v.

NED PUTNAM,

Appellee,

APPELLEE'S REPLY BRIEF UPON CROSS-APPEAL

*Appeal from the United States District Court
for the District of Oregon*

HONORABLE JOHN F. KILKENNY, Judge

DAVIES, BIGGS, STRAYER, STOEL AND BOLEY
CLEVELAND C. CORY
CLARENCE R. WICKS
DON H. MARMADUKE

1410 Yeon Building
Portland, Oregon 97204

*Attorneys for Appellee-
Cross-Appellant*

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APPELLEE'S REPLY BRIEF UPON CROSS-APPEAL

*Appeal from the United States District Court
for the District of Oregon*

HONORABLE JOHN F. KILKENNY, Judge

INTRODUCTION

Defendant agrees with the issues stated by plaintiff with respect to appellee's cross-appeal (App. Reply Br. pp. 12-14). A fair reading of plaintiff's answering brief upon the cross-appeal shows that plaintiff would concede that if the Undertaking did not contain Putnam's advance consent, and if the record did show beyond dispute that the plaintiff did grant

one or more extensions of time for payment to Big Chrome, then the district court erred in failing to direct a verdict for defendant under Philippine law.

ARGUMENT

I

The Undertaking Can Not Be Extended Beyond its Clear Terms and Must Be Strictly Construed in Favor of Defendant

In defendant's opening brief upon cross-appeal, the Court's attention was directed to Article 2055 of the Civil Code of the Philippines which states: "A guaranty is not presumed; it must be express and cannot extend to more than what is stipulated therein." Pursuant to this mandate, the Philippine Supreme Court has refused to extend a guaranty ". . . farther than the clear terms of the contract of guarantee by mere implications." (*Solon v. Solon*, 64 Phil. 729, 734)

Plaintiff does not take issue with this rule of strict construction which favors defendant. Nevertheless, plaintiff advances three separate arguments to the effect that the Undertaking contained a "built-in" consent by defendant to allow plaintiff to grant Big Chrome extensions of time for payment, without thereby releasing defendant:

(1) First, plaintiff points to the second paragraph of the instrument and, particularly, to the phrase, "and the time of payment thereof extended." Plaintiff notes that in the district court defendant contended that the antecedent of "thereof" is the

phrase "the securities of every kind," so that the clause gave the plaintiff the right to extend the time of payment of any securities left with it as collateral, without first obtaining defendant's consent. In fact, that defendant's construction of the phrase is the only fair and reasonable interpretation may be inferred from the fact that the district court did not allude to plaintiff's strained construction in the court's pretrial memorandum (R. pp. 7-8), or in its opinion denying defendant's motion for a directed verdict (R. pp. 86-87). Even plaintiff's counsel agrees that defendant's interpretation ". . . may have some merit in terms of the parsing of the quoted sentence" (App. Reply Br. p. 14).

Plaintiff maintains that the defendant's construction limiting the express consent to extensions of time with respect to pledged collateral does not make any sense at all in the context of ordinary Philippine banking transactions. Plaintiff further states ". . . an advance consent from a guarantor allowing the bank to grant extensions of time to the issuers of securities held as collateral would be meaningless" (App. Reply Br. p. 16).

Quite to the contrary, as pointed out by defendant's counsel (Tr. pp. 13-15), the provision is necessary as to such collateral since under Philippine law the bank could not foreclose pledged items without risking the extinguishment of the principal obligation, and the guarantor's accessory liability thereon. Article 2115 of the Civil Code of the Philippines clearly states, in part:

“The sale of the thing pledged shall extinguish the principal obligation, whether or not the proceedings of the sale are equal to the amount of the principal obligation, interest and expenses in a proper case. . . .”

(2) Plaintiff further quotes the phrase in the Undertaking that the guarantor “. . . will at any time on demand pay to . . .” plaintiff the above-mentioned obligation of the principal. However, it is conceded that this clause “. . . does not deal directly with the effect of time extensions on the guarantor’s liability” (App. Reply Br. p. 16).

(3) Plaintiff’s principal reliance is upon the last paragraph of the Undertaking which states that the guarantor shall be released from its liability only after the principal or the guarantor has fully paid or satisfied its above-mentioned obligations with plaintiff. Prior to the trial, the district court did construe this language as giving plaintiff the right to extend the time of payment of the obligation without defendant’s consent (R. p. 7). After considering the testimony and the post-trial motions, the court stated: “Quite candidly, I now doubt the validity of that ruling” (R. p. 82) and then stated in some detail (R. pp. 86-87) the reasons for the court’s doubts under Philippine law. The one obvious argument bolstering the trial court’s opinion on this question is that the last paragraph of the Undertaking does not express in clear language a consent by the guarantor to the bank to extend time for payment by the principal debtor. Under the Philippine law, above cited, such consent can-

not be deduced by implication, or by contending, in plaintiff's words, that ". . . the Undertaking taken as a whole clearly contains Putnam's advance consent . . ." (App. Reply Br. p. 19).

Finally, in its construction of the Undertaking, this Court should follow the admonition of Article 1377 of the Civil Code of the Philippines [formerly Article 1288]: "The interpretation of obscure words or stipulations in a contract shall not favor the party who caused the obscurity." As the trial court stated: ". . . the language of a contract should be construed against the person, such as the plaintiff, employing the language" (R. p. 8).

II

The Bank's Correspondence with Big Chrome (Exs. 17(a)-17(u)) Clearly Shows That it Granted Big Chrome One or More Extensions of Time for Payment

Plaintiff's first contention is that the above correspondence fails to show any positive contract between plaintiff and Big Chrome for an extension of time for payment, but rather that the plaintiff imposed ". . . a succession of deadlines for payment by Big Chrome if it would avoid litigation" (App. Reply Br. p. 20).

The short answer is that Big Chrome's first letter of October 14, 1964 requested ". . . your further and kind consideration to allow us thirty days from date hereof within which to pay the first or all amortizations on our L/C 63/252 (DEF) for the machinery

and equipment we imported through your Bank" (Ex. 17(b)). The answer to this request for extension of time for payment is contained in the letter of November 16, 1964, written to Big Chrome by plaintiff's president, stating in part: ". . . please be informed that we are giving in to your request for extension but only up to December 15, 1964. . . . Suffice it to say that in granting you this last extension for payment, we are relying solely on the good faith and integrity of the persons who are in the reins of Big Chrome Exploration Co., Inc. Confident that your obligation will be met within the above period, we look forward to more banking transactions with you" (Ex. 17(e)). In its reply dated November 27, 1964, Big Chrome acknowledged the ". . . extension of time for the payment of our overdue amortization which you have graciously granted us and for which we wish to extend our thanks . . ." (Ex. 17(f)).

Thus, even though the further extensions of time, evidenced by Exhibits 17(i), 17(k), 17(m) and 17(o), be construed merely as stating deadlines "before which Big Chrome must put its account in order if it would avoid foreclosure or other proceedings" (App. Reply Br. p. 22), the above-quoted November 16, 1964 letter and its acknowledgment by Big Chrome, under date of November 27, 1964, did constitute a "positive contract" for a time extension within the governing case of *Radio Corporation of the Philippines v. Roa*, 62 Phil. 211.

In that case, it was held that the act of Radio

Corporation in extending the payment of an installment for some sixty days, without the consent of the guarantors, constituted in fact an extension of the whole amount of the indebtedness, where there was an automatic acceleration clause, as by that extension the plaintiff could not have filed an action for the collection of the whole indebtedness until after the extended date. Therefore, the guarantors were discharged pursuant to Article 2079 of the Civil Code of the Philippines.

The similarities between the *Radio Corporation* case and the case at bar are striking. In both cases, there was a request by the principal debtor for an extension of time for payment of an installment, and an automatic acceleration clause making the principal amount due and payable in full upon failure to pay any one installment (Ex. 5, R. p. 12). In neither case had the guarantor consented to the time extension.

Obviously, plaintiff cannot avoid the impact of the *Radio Corporation* case by claiming that it elected not to demand acceleration. As the Philippine court stated in that case (62 Phil. at pp. 216-217) “. . . under the express provision of the contract, quoted above, the whole unpaid balance automatically becomes due and payable upon failure to pay one installment.” In the case at bar, the principal balance became due and payable upon Big Chrome's failure to pay the first installment on June 28, 1964 (Tr. pp. 72-73).

Plaintiff also claims that there was no consideration for plaintiff's extension of time for payment and that Big Chrome promised nothing in return (App. Reply Br. p. 22). Big Chrome's letters are to the contrary. The letter dated October 14, 1964 (Ex. 17(b)) stated in part:

"We therefore, assure your Bank that with the little more time we are herein requesting, we hope to settle our obligation in full. We would like to make mention that whether we obtain our loan from the DBP or from other sources, we shall have to pay the amount due your Bank in one lump sum inasmuch as we have to mortgage all our machinery and equipment to the financiers."

The next letter, dated November 13, 1964 (Ex. 17(d)), again stated Big Chrome's purpose to pay "our account with your bank in full."

Plaintiff's reply, dated November 16, 1964 (Ex. 17(e)) noted the Bank's confidence "that your obligation will be met within the above period (December 15, 1964]."

Finally, plaintiff suggests that defendant was not entitled to a directed verdict because "... the meaning and effect of the Bank's said letters was a vigorously disputed question for the jury" (App. Reply Br. p. 24).

At the trial, the author of most of the bank's letters, Mr. Pineda, admitted that many of the letters gave Big Chrome additional time to pay (Tr. pp. 118-

121). With reference to the crucial letter of November 16, 1964 (Ex. 17(e)), the witness gave an affirmative answer to the question: "The letter speaks for itself, doesn't it, Mr. Pineda?" There can be no issue of fact as to Mr. Pineda's authority. On recross-examination, he admitted that in writing the letters to Big Chrome he consulted with the plaintiff's president, Mr. Sison, and was just carrying out his instructions (Tr. p. 127).

In any event, in the absence of any latent ambiguity in the writing, the general rule is applicable here that where the determination of a case depends upon the construction of written correspondence, and there is no other evidence from which different inferences can be drawn, it is the court's duty on motion to direct a verdict (*Zehr v. Wardall*, 134 F.2d 805, 809 (C.A. 6); see: *Crowe v. Gary State Bank*, 123 F.2d 513 (C.A. 7); *Equitable Life Assur. Soc. v. Wells*, 101 F.2d 608 (C.A. 5); cf. *Quon v. Niagara Fire Ins. Co. of New York*, 190 F.2d 257 (C.A. 9); see also 9 *Wigmore on Evidence*, (Third Edition) § 2556, pp. 522-524).

To summarize, the trial court was correct in holding that "... there is no question but that an extension of time was actually granted and that defendant did not consent to such extension or extensions" (R. p. 86). Since the Undertaking cannot be construed to contain a "built-in" consent to extensions of time, the Philippine law and, in particular, the case of *Radio Corporation of the Philippines v. Roa*, 62 Phil. 211,

required the trial court's determination under Rule 44.1 F.R.C.P. that defendant's motion for a directed verdict should have been allowed.

CONCLUSION

Irrespective of plaintiff's appeal, and for the reasons stated above and heretofore briefed in defendant's opening brief upon cross-appeal, the judgment for defendant should be affirmed, with costs to defendant.

Respectfully submitted,

CLEVELAND C. CORY
CLARENCE R. WICKS
DON H. MARMADUKE
Attorneys for Appellee
and Cross-Appellant

No. 23019 ✓

FEB 2 1969

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

BAKER COMMODITIES, INC., a California Corporation,
Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

On Petition for Review of the Decision of the Tax Court
of the United States.

BRIEF FOR APPELLANT.

HILL, FARRER & BURRILL,
GILLIN & SCOTT,
CARL A. STUTSMAN, JR.,
JACK R. WHITE,
GLENN M. ALPERSTEIN,

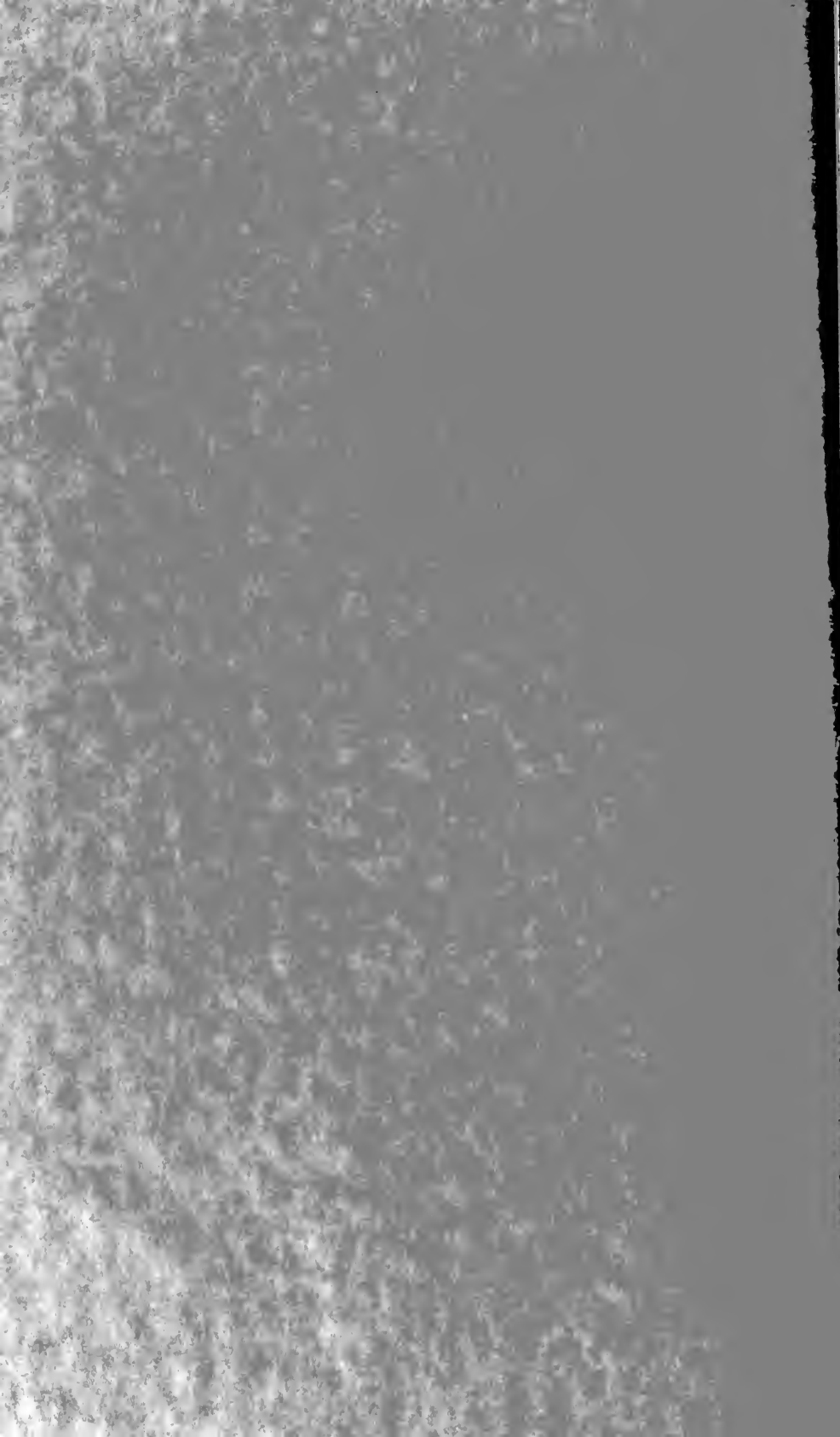
445 South Figueroa Street,
Los Angeles, Calif. 90017,

Attorneys for Appellant.

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No. 23019

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

BAKER COMMODITIES, INC., a California Corporation,
Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

On Petition for Review of the Decision of the Tax Court
of the United States.

BRIEF FOR APPELLANT.

JURISDICTION.

This case comes before the court by virtue of appellant's petition for review of a decision of the Tax Court of the United States entered February 27, 1968. [T. 162].¹ The petition for review was timely filed with the Clerk of the Tax Court in March 28, 1968. [T. 164.]

The Findings of Fact and Opinion of the Tax Court [T. 86-156] were filed February 23, 1967, and offi-

¹The designation "T." refers to the Transcript of Record, Volume One, consisting of documents filed with the Clerk of the Tax Court, including the Findings of Fact and Opinion of the court. The designation "R." refers to the Reporter's Transcript of proceedings before the court.

cially reported at 48 T.C. No. 39.² The Tax Court's decision upheld appellee's determination of deficiencies against appellant to the extent of \$291,237.69 for the taxable year ended June 30, 1962, and \$137,732.54 for the taxable year ended June 30, 1963. [T. 162-163.]

Appellant is a California corporation, with its principal office in Los Angeles. Appellant filed its income tax returns for the years in question with the District Director of Internal Revenue at Los Angeles. Jurisdiction and venue are conferred upon this court by 26 U.S.C. 7482 and 7483. Jurisdiction was conferred on the Tax Court by 26 U.S.C. 6213 and 7442.

QUESTIONS PRESENTED.

This appeal challenges the correctness of the Tax Court's holding that appellant was properly denied a stepped-up basis under Section 334(b)(2) of the Internal Revenue Code for assets received in the liquidation of certain wholly owned subsidiary corporations. The Tax Court's grounds for such decision, which involve the interrelationship of several sections of the 1954 Code, present the following basic questions:

1. Whether an intended sale of property to a newly formed corporation by one not in control of such corporation must, as a matter of law, be treated

²For the purposes of trial and decision the case involving appellant's alleged deficiencies was consolidated with three other cases involving deficiencies asserted against three individuals, Frank Jerome, Paul Jerome and Varney Jerome and their respective spouses. However, the deficiencies against the individuals were disapproved by the court and those cases are not part of this appeal.

as a non-taxable “exchange” of such property for a “security” within the purview of Section 351 of the Code, solely because the purchase price takes the form of a secured 15 year installment note instead of cash or a short term note.

2.(a) Whether a limited partnership formed to engage in a specific enterprise, which sells its only assets and thereafter engages in no further business, terminates for tax purposes on the date of sale under Section 708(a) of the Code.

(b) Whether, in the absence of a technical termination under Section 708(b), such partnership remains within the purview of Section 318 of the Code, so that even after it sells its assets and ceases to operate, the former partners are deemed constructive owners of each other’s stock in an unrelated venture.

(c) Whether, in any event, the Tax Court correctly interpreted the constructive ownership rules of Section 318 as requiring multiple and compound attribution of stock ownership which creates the ultimate effect of a conclusive presumption that the parties did not deal at arm’s length, even though such presumption is contrary to the court’s express findings.

STATUTES AND REGULATIONS INVOLVED.

The relevant provisions of the Internal Revenue Code of 1954 and applicable Treasury Regulations are set out in Appendix A, *infra*.

STATEMENT OF THE CASE.

Nature of the Controversy.

The evidence in this case consisted of a partial stipulation of facts [T. 62-78], numerous documents and the testimony of several witnesses. The issues raised herein do not involve any dispute over the facts. Appellant agrees with the Tax Court's comprehensive specific findings [T. 89-124] which are fully supported by the record. It is only the Tax Court's conclusions which are questioned by this appeal.

The principal transaction with which this appeal is concerned involved appellant's claim of a so-called step-up in basis for assets received in the liquidation of two subsidiary corporations in 1961. Appellant acquired all of the stock of both corporations on June 26, 1961, pursuant to two "Agreements of Purchase and Sale," giving secured 15 year installment notes to the respective sellers for the purchase price. Since the corporations were purchased in order to acquire their assets in a "Kimbell-Diamond" transaction, appellant immediately liquidated them and computed its basis for the assets thus received by allocating to them the purchase price paid for the stock in accordance with Section 334(b)(2) of the Internal Revenue Code.³

The Tax Court concluded, however, that appellant's acquisition of the stock in question did not qualify as

³Section 334(b)(2) is a codification of the rule enunciated in the case of *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), affd. *per curiam* 187 F. 2d 718 (5th Cir. 1951), cert. denied 342 U.S. 827 (1951). The gist of the rule is that a purchase of stock and liquidation of one corporation by another for the purpose of acquiring the assets of the former is treated for tax purposes the same as a straight purchase of the assets. In other words, the substance of the transaction controls rather than its form; and instead of being unfairly required to assume the liquidated corporation's old depreciated basis, the purchasing corporation is allowed a new basis equal to cost of the assets, measured by the purchase price paid for the stock.

a "purchase" within the meaning of Section 334(b)(2) on the ground that the transaction must be treated as a non-taxable "exchange" under Section 351, rather than as a purchase and sale. Section 334(b)(3)(B) specifically excludes Section 351 exchanges from the definition of "purchase" for purposes of applying Section 334(b)(2). A parent corporation liquidating a subsidiary, the stock of which was acquired other than by "purchase," is required to use the subsidiary's basis for the assets distributed. [T. 137-148.]

The court further held, as an alternative ground for denying the step-up in basis, that the stock purchased on June 26, 1961 was acquired by appellant from persons whose stock was attributable to appellant under the constructive ownership rules of Section 318 of the Internal Revenue Code. Under Section 334(b)(3)(C), the acquisition of such constructively owned stock would not qualify as a "purchase" entitled to the benefits of Section 334(b)(2) even if the transaction was otherwise treated as a sale to appellant, rather than as a Section 351 exchange. [T. 148, 151-156.]

Finally, the Tax Court also denied appellant a stepped-up basis under Section 334(b)(2) with respect to assets received in the liquidation of another subsidiary corporation, the stock of which was acquired on December 20, 1962. The court recognized that the 1962 transaction was a purchase and sale (not subject to Section 351) but held that Section 334(b)(3)(C) precluded a stepped-up basis on the ground that the stock of the acquired corporation had been obtained from persons whose stock was attributable to appellant under Section 318. [T. 151-156.]

The deficiencies which were affirmed by the Tax Court are attributable to adjustments resulting from the disallowance of a stepped-up basis for the assets ac-

quired in the 1961 and 1962 transactions. All other disputed adjustments were resolved in favor of appellant by the court's decision or settled by agreement of the parties. Hence, the only issues on appeal relate to the adjustments to basis.

Facts Relating to the 1961 Transaction.

Before reaching the specific terms of the June 26, 1961 sale to appellant, the background and circumstances surrounding the transaction should be examined to put it in proper perspective for the legal questions raised by this appeal.

Three brothers, Frank, Paul and Varney Jerome, have been equal business partners since 1929 under the name of Jerome Brothers. In 1937 they went into the business of rendering animal meat by-products into tallow and animal feeding fat. [T. 90.]

By June of 1961, the partnership owned interests in four corporations which were engaged in the rendering business; and the partnership itself carried on a rendering business in several parts of the country. The corporations were Baker Commodities, Inc. (herein called "Old Baker"), Phoenix Tallow Company (herein called "Phoenix") Kerman Tallow Works (herein called "Kerman"), and San Joaquin Packing Company (herein called "San Joaquin"). The Jerome Brothers partnership owned 100% of the stock of Old Baker and Phoenix and 50% of the stock of Kerman and San Joaquin. The remaining 50% of the stock of Kerman and San Joaquin was owned by R. S. Wilson Company (herein called "Wilson Co."), a California corporation, owned entirely by Robert S. Wilson, who was unrelated to the Jeromes. [T. 91-92.]

Beginning in the early 1950's, the three Jerome brothers began to consider the problem of perpetuat-

ing and disposing of their widespread rendering business. They had reached maturity and had interests in other parts of the world, but had no relatives who could assume the top management of their business. Accordingly, they became concerned about its future ownership and management after their death, and determined that they should sell it and transfer control to a group of men who held key positions in the enterprise (herein referred to as "keymen"). [T. 93, 132, 136; R. 35-37, 248.]

The seven keymen who were ultimately selected by the Jerome brothers for this purpose were James Andreoli, Laverne A. Nelson, Louis J. Frederick, Frank Shultz, Walter Sanderson, J. E. Rickert and Jack Keith. All but Keith were employees of the Jerome Brothers partnership, holding managerial and responsible administrative positions. Keith was an engineer who had done considerable work for the Jeromes including the development of much of the equipment and techniques which they used in their rendering business. He was also a partner with them in a separate partnership called Keith Engineering Company. [T. 93-94, 129.]

In the late 1950's, the Jeromes began informal discussions with the seven keymen about the possibility of giving them an opportunity to acquire a part ownership in the business. Between 1959 and 1961 there were several conversations among the parties about such a transaction and by 1961 they had begun to discuss specific terms. [T. 94.] During the discussions, one of the keymen, Andreoli, ordered independent appraisals of most of the fixed assets used in the partnership's business (including those owned by the corporations) in order to accurately determine their value for purposes of negotiation. [T. 94-96.]

Ultimately, the 1961 negotiations resulted in all ten individuals agreeing that \$3,212,000 was a fair price for the partnership's assets. The trial court expressly found that it was in fact a fair price, negotiated at arm's length. [T. 96, 136-137.]

No part of the negotiated price was attributable to good will. [T. 96, 112-113.]

Since the seven keymen were not financially able to raise sufficient personal capital to pay any substantial part of the purchase price, it was necessary that it be paid off out of earnings of the business over an extended period of time. [T. 97, 132.] At first, the Jeromes wanted an initial payment of \$300,000 and the balance over a ten-year period. But the keymen believed \$300,000 was too high and, based upon a market projection by Frederick and cash flow analysis by Andreoli, felt that it would require 15 years to pay off the purchase price out of earnings. After further negotiations, the Jeromes agreed to accept an initial payment of \$150,000 and 15 year pay-off. [T. 97, 129-130.]

After the basic terms of the contemplated sale and purchase had been agreed to among the parties, they consulted an accountant and attorneys for the purpose of carrying it out in the most beneficial manner from a tax point of view. [T. 98.] The Jeromes were expressly advised by their counsel that if each of the seven keymen were permitted to acquire a 10% interest in the business, the brothers would lose control inasmuch as their ownership would be reduced to only 30%. However, the brothers wished to proceed with the agreement because they did not intend to retain control after the sale. [T. 109, 135, 136.]

It was decided that the purchasing entity should be a corporation in which each of the seven keymen and the three Jeromes owned an equal interest. To accom-

plish this, the parties chose to activate appellant which had been dormant since it was organized on May 14, 1956 under the name of American Extraction Co. On May 2, 1961, appellant's name was changed to Jerome Brothers. Pursuant to a permit obtained from the California Commissioner of Corporations on June 23, 1961, appellant issued 5 shares of its common stock to each of the ten individuals for a capital contribution of \$500 from each. [T. 99.]

On June 15, 1961, to facilitate the sale of the entire rendering business conducted by their partnership, the Jeromes contributed all of their non-corporate operating divisions to the capital of Old Baker subject to certain liabilities. [R. 148; Ex. 49, 50.] Appellant then entered into an "Agreement of Purchase and Sale" with the Jerome Brothers partnership on June 26, 1961, thereby purchasing the partnership's 100% of the stock of Old Baker and Phoenix and 50% of the stock of Kerman and San Joaquin, along with two parcels of real estate used in connection with the partnership's rendering business. [T. 100.]

Under the terms of said "Agreement of Purchase and Sale," the purchase price of \$3,212,000 was payable in the form of a promissory note for \$3,150,000 plus an assumption of indebtedness in the amount of \$62,000. The note called for an initial payment of \$150,000 in four days (June 30, 1961) with the balance of the principal in 15 equal annual installments of \$200,000 commencing June 30, 1962. Interest was payable at the level rate of \$40,000 semiannually. [T. 100; Ex. 4-D.]

The agreement further provided that each of the ten stockholders of appellant was required to pledge 4.6 of his 5 shares, or 92% thereof, with the attorneys for the parties acting as pledgeholder, for the purpose of

securing payment of the promissory note. [T. 101.] The pledge agreement, incorporated by reference into the agreement of purchase and sale, expressly provided that the stockholders would retain their voting rights while the stock was pledged. [T. 103; Ex. 4-D.]

In addition, the agreement imposed certain restrictions on the corporation so long as any part of the promissory note remained unpaid. The trial court observed that the reason for the restrictions was to protect the Jerome Brothers partnership, as a creditor, from indiscriminate acts of management which might severely affect appellant's ability to make timely payments on the note. The court said the restrictions were not of a nature which would permit the Jeromes to bind the corporation whenever they desired; they were not intended to give the Jeromes "effective control," nor did they do so in fact. [T. 134-136.]

Also on June 26, 1961, appellant and its shareholders entered into another "Agreement of Purchase and Sale," with the Wilson Co., pursuant to which appellant purchased the remaining 50% of the corporate stock of Kerman and San Joaquin. The agreement provided for a total purchase price of \$250,500 to be evidenced by a promissory note in that amount with interest at the rate of 6% per annum on the unpaid balance. Principal and interest were payable in thirty semiannual installments of \$12,725.40 each. In all other respects such agreement contained the same terms, provisions and conditions as the agreement entered into on the same day between appellant and the Jerome Brothers partnership, including a pledge agreement whereby each of the ten stockholders of appellant pledged the remaining four tenths of a share of their stock in appellant to secure payment of the purchase price to the Wilson Co. [T. 105-106; Ex. 5-E.]

Immediately after purchasing all of the stock of Old Baker and Kerman, appellant adopted a plan of complete liquidation of those wholly owned subsidiaries. By June 30, 1961, the liquidations were carried out and the assets of Old Baker and Kerman were distributed to appellant in cancellation of their stock. The corporate resolutions expressly indicated that such liquidations were intended to be in accordance with Section 332 of the Internal Revenue Code. [T. 106-107; Ex. 7-G.]

Shortly thereafter, appellant's internal auditing staff and outside accountant allocated the purchase price of the stock of Old Baker and Kerman to the various tangible assets acquired by appellant from those corporations in order to determine their basis for tax purposes. The allocations were based principally on the independent appraisals obtained during the negotiations. [T. 106-108; Ex. 51.]

At all times subsequent to June 30, 1961, appellant has continued to carry on the businesses formerly conducted by Old Baker and Kerman. Appellant's corporate name was changed to Baker Commodities, Inc. on July 25, 1961. The other two corporations appellant acquired, Phoenix and San Joaquin, remained wholly owned subsidiaries. [T. 99, 106-107.]

At all times from June 26, 1961, to the time of trial, each of the stockholders of appellant except Keith has been an employee of appellant. [T. 108.] Moreover, a shift in fact occurred in management responsibilities and authority. The keymen not only had voting control over appellant by virtue of their ownership of 70% of its stock, they actually assumed more responsibility and more administrative control over appellant's operations. [T. 109, 135-136; R. 42-43, 70, 165-166, 193, 263-264, 278-279, 291.]

At no time after appellant acquired the partnership's assets was there an agreement, oral or written, or any tacit understanding between the Jerome brothers and the seven keymen restricting the latter's rights to vote their stock in appellant. [T. 111.]

During the four years following the change in ownership, under the increasing direction and control of the keymen, the business enjoyed its greatest financial success. Both net sales and earnings increased substantially over what they had been under the Jerome Brothers partnership. [T. 108-109, 130, 136; Ex. 41.]

There have been no defaults under the purchase and sale agreements of June 26, 1961. As of the time of trial, all payments of principal and interest on the notes to the Jeromes and the Wilson Co. had been made out of appellant's current earnings, and the agreements remained in full force and effect. [T. 104; Ex. 6-F; R. 164.] The trial court observed that this fact "well attests to the sound business judgment exercised by the keymen in arriving at a 15-year period." [T. 130.]

On audit of appellant's income tax returns for the fiscal years ended June 30, 1962 and June 30, 1963, appellee disallowed a new basis to appellant under Section 334(b)(2) for the assets acquired in the 1961 purchase and liquidation of Old Baker and Kerman. Such disallowance resulted in the following adjustments: (1) for the taxable years ended June 30, 1962, and 1963, appellant's depreciation deductions were reduced by the sums of \$391,557 and \$202,855, respectively; (2) for the year ended June 30, 1962, appellant's deduction of a loss in the amount of \$108,228.57 on the sale of certain assets was disallowed and it was determined instead that appellant realized a gain of \$31,820 on such sale; and (3) for the year ended June 30, 1962, appellant's opening inventory was reduced by the sum of

\$104,190.76, thereby reducing its deduction for cost of goods sold by that amount. [T. 35, 40.]

The 1962 Transaction.

A Panamanian corporation known as Veronica Compania Naviera, S.A. (herein called "Veronica") was organized by the three Jerome brothers on or about August 15, 1956. By an "Agreement for the Sale of Stock" dated December 20, 1962, appellant acquired all of the issued and outstanding stock of Veronica from the Jerome brothers. [T. 118-121; Ex. 8-H.] The total purchase price was \$1,100,000, of which \$350,000 represented the estimated value of a certain marketing agreement between Veronica and a Philippine corporation, Legaspi Oil company. [T. 120.]

Pursuant to a plan of liquidation, Veronica was liquidated under the laws of the Republic of Panama on December 31, 1962, and all of its assets and liabilities, including the Legaspi marketing agreement, were transferred to appellant. In computing basis for tax purposes, in accordance with Section 334(b)(2) of the Internal Revenue Code, appellant allocated the purchase price of the stock to the assets acquired from Veronica, with the sum of \$350,000 being allocated to the marketing agreement. Such marketing agreement subsequently proved to be of greater value than was estimated by the parties. [T. 121-123.]

On its income tax return for the fiscal year ended June 30, 1963, appellant deducted \$25,800 as amortization of the cost of the Legaspi marketing agreement using the basis of \$350,000 for such agreement. On audit of said return, appellee determined that appellant was not entitled to a new basis for the assets received in liquidation of Veronica under Section 334(b)(2). Since the Legaspi marketing agreement had no cost

to Veronica, appellee's determination that appellant was required to use Veronica's basis resulted in the complete disallowance of any deduction for amortization. [T. 40, 122, 124.]

The Constructive Ownership Question.

The Tax Court concluded that at the time of both the 1961 and 1962 transactions the Jerome Brothers partnership owned more than 50% of appellant's stock by virtue of the constructive ownership rules of Section 318 of the Internal Revenue Code. Such determination, in turn, was deemed to have activated another rule under Section 318 which would attribute to appellant any stock owned by the Jerome Brothers partnership in Old Baker, Kerman and Veronica. Hence, appellant was denied the benefits of Section 334(b)(2) upon the acquisition of the Old Baker, Kerman and Veronica stock because Section 334(b)(3)(C) expressly excludes from such benefits an acquisition from a person whose stock is attributable to the acquiring corporation.⁴

The assumed ownership of more than 50% of appellant's stock by the Jerome Brothers partnership—which triggered the other rules—is the result of the Tax Court's conclusion that a limited partnership, Manchester Medical Hospital (herein called "Manchester"), was in existence on June 26, 1961 and December 20, 1962 for the purpose of applying the constructive ownership rules. Under those rules, as interpreted by the court

⁴Actually, the stock of Veronica was owned by the Jerome Brothers individually rather than by the Jerome Brothers partnership. [T. 188.] However, such stock would be owned constructively by the partnership under Section 318. As for Kerman, although only 50% of the stock was acquired from the Jerome partnership, disqualification of such purchase under the attribution rules would be enough to preclude the benefits of Section 334(b)(2) as to all of Kerman's stock.

below, appellant's stock owned by five of the keymen who were partners in Manchester would be attributable to Manchester; and the Jeromes would be deemed to own the same percentage of such stock as their partnership interest in Manchester. [T. 151-156.]

As will be shown *infra*, attribution through Manchester, if applicable, would add 16.5% to the percentage of appellant's stock owned by the Jeromes actually and constructively. The three Jeromes together owned 30% of appellant's stock actually; and the trial court concluded they owned another 5% constructively because they were 50% partners with Jack Keith in Keith Engineering.⁵ Hence, if this combination is permitted by the Code, the 16.5% attributed through Manchester would push the Jeromes over the crucial 50% mark with a combined total of 51.5%.

The facts concerning Manchester are as follows:

On or about January 1, 1958, Manchester was formed as a limited partnership by 15 individuals, including eight of the men who later became stockholders of appellant. It was created for the sole purpose of constructing, owning and operating a convalescent hospital. The respective percentages of such partnership owned by the various general and limited partners are set forth in the Tax Court's Findings. [T. 114.]

Manchester was at all times a completely separate and independent entity whose business of operating a convalescent hospital was in no way connected with that of any other business involved in this proceeding. [T. 114.]

⁵Unlike the Manchester partnership, there is no question that the Keith Engineering partnership was in existence, engaging in business, at the time of the 1961 and 1962 transactions. If attribution through the latter partnership, in combination with the other rules, was proper under the circumstances of this case, the Jeromes would own constructively one-half of Keith's stock.

Pursuant to the purpose for which Manchester was formed, a convalescent hospital was in fact built and operated by it. The partnership ran into severe financial difficulties, however, and the hospital was closed on or about July, 1960. On March 1, 1961, the partnership, by installment sale, conveyed all of its assets to Southwest Community Hospital Association, a non-profit corporation which was unrelated to any of Manchester's partners or any of the parties or entities involved in this case. The buyer gave a promissory note for the purchase price, secured by a chattel mortgage and deed of trust. The buyer commenced operating the hospital for its own account on or about March 1, 1961. [T. 114-115.]

After March 1, 1961, Manchester no longer engaged in any business of any sort. [T. 115; R. 157-158.]

In order to report income received from the 1961 installment sale, a partnership tax return was prepared and filed for Manchester for 1961 and 1962. Manchester's final tax return for the fiscal year ended August 31, 1962, reported collections on the installment sale in the amount of \$36,623.97. No other receipts or gross income and no deductions were reflected on said return. It reflected an unpaid balance of \$12,500 on the purchaser's note. [T. 115.]

Specification of Errors Relied Upon.

The Tax Court erred in the following respects:

1. The court misinterpreted and misapplied the provisions of Section 351 of the Internal Revenue Code (ignoring long standing judicial construction of its meaning, purpose and scope) and erroneously held that the June 26, 1961 sale by the Jerome Brothers partnership and Wilson Co. to appellant must be treated as a non-taxable "exchange" for a "security" within the purview of the statute.

2. The court misconstrued the meaning and purpose of Section 318 of the Internal Revenue Code by erroneously holding that Manchester limited partnership did not terminate, at least for stock attribution purposes, on March 1, 1961, when it sold all of its assets and ceased to engage in business.
3. The court further misconstrued Section 318 as requiring multiple and compound stock attribution in a fashion which produces an arbitrary, inequitable result which was not intended by the statute.
4. As the result of the foregoing errors, the court erroneously denied appellant a stepped-up basis under Section 334(b)(2) of the Internal Revenue Code for the assets received in liquidation of the subsidiary corporations (Old Baker and Kerman) which appellant purchased on June 26, 1961.
5. As the result of the misconstructions of Section 318 referred to above, the court also erred in denying appellant a stepped-up basis under Section 334(b)(2) for the assets of the subsidiary corporation (Veronica) which appellant purchased and liquidated in 1962.

SUMMARY OF ARGUMENT.

I.

As previously indicated, the first major issue in this case concerns the Tax Court's holding that the June 26, 1961 transaction must be treated as a non-taxable "exchange" governed by Section 351 of the Internal Revenue Code. This served as the court's principal ground for denying appellant a stepped-up basis under Section 334(b)(2) upon the subsequent liquidation of Old Baker and Kerman. It is appellant's contention that the court's conclusions with respect to such issue are contrary to settled principles of law.

The unquestioned legislative purpose of the non-taxable exchange provisions of the code dealing with corporate organizations and reorganizations (including Sec. 351) is to permit taxpayers to change the form of their investment in property without having to recognize unrealized gain. They were never intended to apply to a "sale" whereby a taxpayer "cashes in" his investment and realizes gain through receipt of a purchase price. Accordingly, it has been uniformly held in a long line of judicial decisions that the provisions of Section 351 and its predecessors under prior Revenue Acts do not apply to a bona fide sale.

Under the undisputed facts in this case and the authorities cited herein, the June 26, 1961 transaction was a bona fide sale. The Jerome Brothers partnership and Wilson Co. did much more than merely change the form of their investment in Old Baker, Kerman and the other properties sold to appellant. They transferred actual and beneficial ownership of their stock in those corporations to appellant—a corporation in which the Jeromes owned only a minority interest and the Wilson Co. owned no interest at all. In return, they received a negotiated purchase price payable in installments over the shortest period in which appellant was financially able to meet such obligation. In other words, they "cashed in" their investment, converting from an equity position to that of a creditor, realizing gain in the process.

Although the Tax Court appeared to recognize that the parties intended a sale, and that the transaction was in fact a sale in the economic sense, it concluded nevertheless that Section 351 was controlling. Taking a purely mechanical approach, the court determined that the installment notes for the purchase price were "securities" and automatically required the application of Section 351. The factors relied upon for such de-

termination were the length of the notes' duration (15 years) and the protective provisions of the sales agreements securing payment of the purchase price by appellant.

Such determination not only ignores the meaning and purpose behind Section 351 but it is irreconcilable with existing case law. Indeed, the court's interpretation of the statute and the meaning of the term "security" as used therein has been repeatedly and unequivocally rejected in other cases which are indistinguishable from the instant case.

If the court's interpretation of Section 351 becomes the law, it will make it impossible for a taxpayer to sell property to a newly organized corporation on a long term basis without suffering unintended and unfair tax consequences which bear no relation to the real economic substance of the transaction. Merely because a corporation is financially unable to pay cash or give a short term note for the purchase price, and must pay for the property over a long term, it should not lose its right to use its cost as the tax basis for the assets received. Nor should the seller be treated as having made a non-taxable "exchange" for tax purposes, because he was willing to take a long term pay-off with customary protective provisions, common to all deferred payments sales, securing payment of the purchase price. Yet these arbitrary distinctions are the necessary result of the court's construction and application of the statute.

II.

The second major issue concerns the Tax Court's holding that the constructive ownership rules of Section 318 of the Internal Revenue Code prevented a stepped-up basis on both the June 26, 1961 and December 20, 1962 transactions. The court concluded that at the time of both transactions all of the stock owned by the

Jeromes was attributable to appellant; and, hence, that the stock of Old Baker, Kerman and Veronica acquired from the Jeromes was disqualified for treatment under Section 334(b)(2) by reason of Section 334(b)(3)(C). It is appellant's contention that the court misconstrued the purpose and effect of Sections 318 and 334(b)(3)-(C).

In the first place, the court erroneously concluded that the limited partnership, Manchester, which had sold all of its assets and ceased engaging in business on March 1, 1961, remained an existing partnership for purposes of applying the constructive ownership rules. The presumption which is the basis for attribution to a partnership under Section 318 is that when an individual partner owns stock, it is also owned by his partnership because of the *agency relationship* that exists between them. Similarly, attribution *from* a partnership is based on presumed *beneficial ownership* of partnership property by each partner in proportion to his partnership interest. Obviously, when the agency relationship and beneficial ownership no longer exist as a matter of law, there is no basis for the underlying presumptions and there is no longer a "partnership" within the meaning of Section 318.

Whereas the court apparently based its decision entirely on the assumption that Manchester was not formally "terminated," we will show that under California law and recognized partnership principles there was a "dissolution" on March 1, 1961. As a matter of law, the agency relationship between partners ceased to exist upon such dissolution. To thereafter regard Manchester as a "partnership" within the meaning of Section 318, is to totally ignore the statutory purpose.

Furthermore, appellant contends that Manchester partnership was deemed "terminated" for partnership taxation purposes under Section 708(b). One subsection

of 708(b) provides that if 50 percent or more of the partnership interest is sold in one year, the partnership "terminates" on the date of the sale. The cases hold that a sale of the partnership's entire assets is in effect a sale of the partnership interests. Hence, Manchester terminated under Section 708(b) on the date that all of its assets were sold, March 1, 1961.

Alternatively, Manchester should be regarded as terminated under another subsection of 708(b) by reason of its cessation of business on March 1, 1961. Under that provision, the partnership terminates when the partners cease carrying on a business as a partnership. The only subsequent activity in connection with Manchester was the collection of the purchase price for the sale of the partnership's assets. Such activity cannot be regarded as "carrying on" the partnership business.

Finally, the constructive ownership rules of Section 318 should not be compounded the way they were in the instant case. In order to deny appellant's stepped-up basis under Section 334(b)(3)(C), the court had to combine several rules and multiple steps attributing the same stock. Subsequent to the years in question, Congress amended Section 318 to specifically prohibit so-called double attribution *because it was not within the contemplated legislative purpose*. In the instant case, the court actually added additional steps beyond double attribution, compounding the effect of several rules. This process works an unconscionable injustice. It applies several presumptions concerning stock ownership which have no basis under the facts actually found by the court, in order to invoke another presumption, embodied in Section 334(b)(3)(C), that the parties did not deal at arm's length in the subject transactions—despite an *express finding* that the parties did deal at arm's length.

ARGUMENT.

I.

The Tax Court Erred in Holding That Appellant's June 26, 1961 Purchase of the Stock of Old Baker and Kerman Was Governed by Section 351, Depriving Appellant of a Stepped Up Basis Under Section 334(b)(2) for the Assets Received in Liquidation of Those Corporations.

- A. The Ultimate Question Raised by the Tax Court's Decision on This Issue Is Whether Section 351, Properly Construed, Governs the Tax Treatment of a Transaction Which Had All of the Elements and Economic Effect of a Sale, Merely Because the Purchase Price Took the Form of Long Term Secured Notes.

It should be noted initially that the question presented here is one of law. It requires an interpretation of Section 351 of the Internal Revenue Code of 1954, as applied to the undisputed facts found by the Tax Court and supported by the record. Before embarking on a discussion of appellant's arguments on this issue, we believe a brief comparison of the respective positions of appellant, appellee and the Tax Court will help bring the basic controversy into sharper focus.

Appellant contended below, and still contends, that the June 26, 1961 transaction was a bona fide sale by the Jerome Brothers partnership and Wilson Co., and purchase by appellant. The evidence and findings of the Tax Court show that all of the parties so intended. The legitimate business purpose of such sale was to perpetuate the Jeromes' partnership business, consolidate it with the Wilson Co.'s interest and permit seven key employees to acquire control and equity interests in the entire enterprise; and there was in fact a substantial shift in both ownership and control as the result of the sale. Under the authorities discussed here-

inafter, such transaction does not come within the meaning or purpose of Section 351.

Appellee argued below that despite the form of the transaction it was not a bona fide sale in substance. He contended that appellant was "thinly capitalized" and that the transfer of property by the Jeromes should be regarded as a capital contribution. Hence, appellee urged that the promissory note the Jeromes received for the purchase price represented a proprietary interest, rather than a genuine indebtedness, and should be regarded as the equivalent of "preferred stock." Under this view of the facts, appellee urged that the June 26, 1961 transaction, and the prior issuance of appellant's common stock to the Jeromes and seven keymen, should be taken as a single, so-called "step-transaction" falling within the provisions of Section 351.⁶

The Tax Court rejected appellee's contention that the promissory note was stock, representing a capital contribution, and held that it created a bona fide indebtedness. The court stated that it was "convinced that the note arose out of a transaction which was entered into for valid business reasons, was at arm's length, and was not a sham transaction." [T. 131-132.]

But, to appellant's surprise, after the court concluded that the note was not stock, and in fact created a genuine indebtedness on the part of appellant to pay for the partnership assets, it then held Section 351 nevertheless applied on the ground that the note constituted a "security." After examining some general definitions of that term, it concluded that the *length* of the note and the *protective provisions* of the purchase and sale agreement secured for the Jeromes "the continuing par-

⁶Counsel for appellee indicated in his opening statement to the Tax Court that he would also take the alternative position that the promissory note was a security. [R. 18] However, such contention was not discussed in appellee's brief.

ticipation in the business which is so characteristic of a security interest." [T. 141-142.] Based on the same reasoning, the court also concluded that the note received by the Wilson Co. was a security. [T. 143, n. 25.]

Having thus determined that the notes were securities, the court found the necessary 80% control by the "transferors," to make Section 351 applicable, by treating the prior issuance of stock to appellant's 10 shareholders, and the June 26, 1961 transfers by the Jeromes and Wilson Co., as a single event carried out by a "step transaction." Thus, even though the Jeromes had only 30% of appellant's stock and the Wilson Co. had none, by adding the 70% owned by the keymen, the "transferors" as a group had 100%.

It is important to note that while the Tax Court did not specifically address itself to the question of whether the June 26, 1961 transaction was a sale for other than tax purposes, it was plainly recognized as a sale in the economic sense, so intended by the parties. The court itself repeatedly used such terms as "purchase," "sell," "price" and "pay for" in describing the transaction, and found as facts all of the elements which legally constitute a sale.⁷ There was a shift of actual and beneficial ownership in the transferred property, in exchange for payment by appellant of a consideration which the court found was a "fair price," bargained for at arm's length. [T. 96, 136-137.] Nothing more is needed to constitute a sale.

The court obviously regarded the *intent* of the parties and the *economic and practical effect* of the trans-

⁷Just as one example, at T. 136 the court said: "*The brothers had agreed to sell the partnership's assets to New Baker only after they were advised by counsel that . . . the brothers would lose control inasmuch as their ownership would be reduced to 30 percent.*" (Emphasis added.)

action as immaterial. It believed the proper approach was to simply test the *mechanical steps* taken by the parties to see if they could be made to fit the literal provisions of Section 351, irrespective of their purpose. We will demonstrate in the following sections of this brief that the Tax Court's decision is squarely in conflict with an overwhelming array of well reasoned case authority.

- B. Since Section 351 Is Intended as an Exception to the Rule of Taxability, Applicable Only Where There Is a Mere Change in the Form of the Transferor's Ownership Interest, a Transaction Which Amounts to a Sale Is Not Covered by the Statute and the Purchaser's Obligation for the Purchase Price Is Not a "Security" Irrespective of the Length of Its Term.**

To begin with, it must be recognized that Section 351 is an exception to the general rule that a transfer of property in exchange for money, a promissory note or some other property, is a taxable event. Under Sections 1001 and 1002 of the Code, gain or loss must be recognized on the "sale or exchange" of property, except as otherwise expressly provided in the Code. Sections 351 through 368, dealing with corporate organizations and reorganizations, provide one area of specific exception.

The limited purpose and scope of this exception was clearly defined in *Portland Oil Co. v. Commissioner*, 109 F. 2d 479 (1st Cir. 1940), which involved Section 112(b)(5) of a prior revenue act, the predecessor of Section 351 of the 1954 Code. There, the court stated (at p. 488): "It is the purpose of Section 112(b)(5) to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and eco-

nomie sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture. As was said in *American Compress & Warehouse Co. v. Bender*, 5 Cir. 1934, 70 F. 2d 655, 657, 'The transaction described in the statute lacks a distinguishing characteristic of a sale, in that, instead of the transaction having the effect of terminating or extinguishing the beneficial interests of the transferors in the transferred property, after the consummation of the transaction the transferors continue to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner of it.' "

In other words, the basic premise of this statutory provision is that a transfer of property to a corporation controlled by the transferor, in which the transferor does not "cash in" his investment, is merely a *change in the form of his ownership* and should not call for settling up his gain or loss. Conversely, a *sale*, even to a corporation controlled by the seller, results in *cashing in* and realizing gain or loss, and should not be treated differently from any other taxable sale. *A fortiori*, a sale to a corporation *not controlled by the seller* does not come within any of the reasons for non-taxability under this exception. The statute and the terms used therein must be interpreted and applied to promote this plain legislative intent. *Mertens, Law of Federal Income Taxation*, Vol. 3, Section 20.14.

Hence, it was easily predictable that the statutory predecessor to Section 351 would be held inapplicable to a sale to a corporation for cash or its equivalent. *Tuller v. United States*, 14 F. Supp. 188 (Ct. Cl. 1936). It was once argued, however, that if a purchase price took the form of a corporate note or similar obligation, it might be a "security" and make the transaction a non-

taxable "exchange" within the coverage of the organization and reorganization sections. But that notion was quickly dispelled in a series of important early decisions which analyzed the meaning of the term security in light of the legislative objective. In substance, they held that it is implicit in the statutory provisions that there must be a continuance of the transferor's *proprietary interest* in the enterprise; and that a security within the meaning and purpose of the statutes must effectuate such a "continuity of interest." Since the corporate obligation received by one who sells his property to a corporation does not represent the interest of a proprietor, but rather that of a creditor, the requirement of continuity of interest is lacking and it cannot be a security within the contemplation of these particular revenue laws. See, *Le Tulle v. Scofield*, 308 U.S. 415 (1940); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Neville Coke & Chemical Co. v. Commissioner*, 148 F. 2d 599, 602 (3d Cir. 1945), *cert. denied*, 326 U.S. 726 (1945); *Commissioner v. Sisto Financial Corp.*, 139 F. 2d 253 (2d Cir. 1943); *Lloyd-Smith v. Commissioner*, 116 F. 2d 642 (2d Cir. 1941), *cert. denied*, 313 U.S. 588 (1941); *Cortland Specialty Co. v. Commissioner*, 60 F. 2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1932).

Although most of the foregoing cases involved the sections dealing with reorganizations, the underlying purpose for the exception to taxability embodied in those sections is the same as for Section 351 and its forerunners. Hence, the term "securities" has the same meaning in all of such sections. *Lloyd-Smith v. Commissioner*, *supra*, at 644; *Pacific Public Service Co. v. Commissioner*, 154 F. 2d 713 (9th Cir. 1946).

Nor does it make any difference whether the purchase price is represented by a short term or a long term obligation—notwithstanding the court's erroneous

belief in the instant case that the length of the term was significant. [T. 142.] The rationale which leads to the conclusion that a purchaser's obligation given in connection with a sale is not a security, is the same regardless of the length of the term. This was made abundantly clear by the United States Supreme Court in *Le Tulle v. Scofield, supra*, the leading case on this point. There, the Court held that a transfer of assets to a corporation in exchange for \$50,000 in cash and \$750,000 in bonds, payable serially over a period of 12 years from the date of transfer, constituted a sale rather than a non-taxable reorganization. In so doing, it corrected a misconception that the "continuity of interest" doctrine, enunciated in earlier cases, was limited to short term notes with the following explicit language (at pp. 420-421):

"We are of the opinion that the term of the obligations is not material. Where the consideration is wholly in the transferee's bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee. . . ."

This principle was expressly reaffirmed in several recent decisions involving the analogous situation of the so-called "bootstrap sale" of a going business to a charitable organization, with the purchase price payable over a long term out of the future earnings of the business. *Commissioner v. Brown*, 380 U.S. 563 (1965), affirming both this court (325 F. 2d 313) and the Tax Court (37 T.C. 461); *Estate of Ernest G. Howes*, 30 T.C. 909 (1958), *aff'd sub nom. Commissioner v. Johnson*, 267 F. 2d 382 (1st Cir. 1959); *Estate of Cordie Hawthorne*, T.C. Memo. 1960-146, 19 T.C.M. 770.

C. Decisions Involving Section 351 Have Uniformly Considered the Pivotal Question to Be Whether the Transaction Is in Fact a Bona Fide Sale; and Several Which Are Indistinguishable From the Instant Case Have Expressly Rejected the Theory Adopted by the Court Here.

In the foregoing discussion, we pointed out that a sale to a corporation is not encompassed within the terms or purpose of Section 351 or the other related non-taxable exchange provisions of the Internal Revenue Code. Nor is an intended sale of a going business converted into a non-taxable transfer in exchange for a "security" merely because the purchase price is payable over a long term out of future earnings.

Of course, there can always be a question whether a particular transaction is in fact a bona fide sale. A transaction cast in the form of a sale may be something else in substance. There has been a considerable amount of litigation involving alleged sales to controlled corporations in which it is argued that the subject transaction is in reality a disguised capital contribution which properly should be treated as a non-taxable exchange under Section 351. As in the instant case, the government often contends that a corporation is too "thinly capitalized" and that the note received for the "purchase price" actually represents an *equity* interest in the corporation in the nature of stock.

The cases dealing with this question uniformly treat it as an issue of fact. Basically, it is a question of whether the substance of the transaction is consistent with its form. If the court finds that it was in fact the intent of the parties to make a sale and to create a bona fide indebtedness for the purchase price, the transaction is held not to be covered by Section 351. It does not matter whether the seller also owns some, or

even all, of the stock of the transferee corporation; nor is the length of the term of the purchaser's obligation material. A sale is simply not within the purview of the statute for the reasons stated previously.

In most of these decisions, the court has merely held that because the transaction was found to be a sale, it was not covered by Section 351, without discussing the point raised in the instant case as to whether the note might be a "security" as distinguished from "stock." See, *e.g.*, *Miller's Estate v. Commissioner*, 239 F. 2d 729 (9th Cir. 1956); *Sun Properties, Inc. v. United States*, 220 F. 2d 171 (5th Cir. 1955); *Piedmont Corporation v. Commissioner*, 388 F. 2d 886 (4th Cir. 1968); *Woolley Equipment Co. v. United States*, 268 F. Supp. 358 (E.D. Tex. 1966); *Dixie Portland Flour Co.*, 31 T.C. 641 (1958); *J. I. Morgan, Inc.*, 30 T.C. 881 (1958) (*acq.*), *rev'd on other grounds*, 272 F. 2d 936 (9th Cir. 1959); *Ainsle Perrault*, 25 T.C. 439 (1955), *acq.*, 1956-1 C.B. 5; *Arthur M. Rosenthal*, T.C. Memo. 1965-254, 24 T.C.M. 1373.⁸

The "security" issue has been discussed by the Tax Court in a few cases, however, where it was urged as an alternative argument. In four cases decided prior to the instant case, and one decided subsequently, the Tax Court flatly rejected the contention that a note received for the purchase price in a bona fide sale could be regarded as a "security" within the meaning of Section 351. An analysis of those decisions shows that their rationale cannot be reconciled with the court's decision in the instant case.

The first of such cases was *Warren H. Brown*, 27 T.C. 27 (1956), *acq.*, 1957-2 C.B. 4. There, the pe-

⁸See also, the recent decision of this court in *Murphy Logging Co. v. United States*, 378 F. 2d 222 (9th Cir. 1967). Although the facts of that case differ slightly from the more typical cases cited above, it is clearly in accord with them in principle.

itioner corporation acquired assets from a partnership pursuant to an installment sale contract payable in 10 equal annual installments. The corporation, in which the partners owned all of the stock, was formed for the purpose of buying the partnership's business. Title to the assets was reserved in the partners until the full purchase price was paid. The court held that the transaction was a sale, not a non-taxable exchange under Section 112(b)(5) of the 1939 Code, the immediate predecessor to Section 351 of the present Code. After discussing and rejecting the government's principal argument that the installment note represented a stock interest, the court disposed of the alternative argument that it was, nevertheless, a security, in the following language (at p. 36): "The question whether an evidence of indebtedness constitutes a security does not depend for its resolution upon a simple determination of the length of time the obligation is to run, but depends rather upon an over-all evaluation of the nature of the debt so as to ascertain whether or not the instrument issued evidences a continuing interest in the affairs of the corporation. . . . *The installment contract in question was not intended to insure the partners a continued participation in the business of the transferee corporation, but was intended rather to effect a termination of such a continuing interest.* We are aware of no decision in which an installment sales contract reserving title in the seller has been held to qualify as a security within the meaning of Section 112(b)(5) of the Code, and respondent has cited none.

Although in certain particulars the contract may resemble a bond, essentially it partakes of the nature of a contract of sale, and in our view does not constitute a security within the meaning of Section 112(b)(5) of the Code." (Emphasis added.)

Two things should be immediately evident from the *Brown* case: First, although it did not cite *Le Tulle v. Scofield*, discussed previously, the Tax Court correctly applied the Supreme Court's rationale in the context of Section 112(b)(5); secondly, such rationale conflicts diametrically with the Tax Court's decision in the instant case.

Two years later, the Tax Court again faced this question in *Harry F. Shannon*, 29 T.C. 702 (1958), where assets were transferred to a corporation in exchange for a corporate note payable in 49 annual installments. The corporation was formed for the purpose of acquiring the assets and all of its stock was issued to the noteholders concurrently with the transfer of assets. It was found that the transaction was a sale, not an exchange under Section 112(b)(5), relying primarily on *Warren H. Brown* and *Sun Properties, Inc. v. United States*, *supra*, but also citing *Le Tulle v. Scofield*. The court stated that because of such holding, it was unnecessary to discuss the question of whether the installment obligation might be deemed a security if the transaction were other than a sale.

Similarly, in *Arthur F. Brook*, T.C. Memo. 1964-285, 23 T.C.M. 1730, *rev'd on other grounds*, 360 F. 2d 1011 (2nd Cir. 1966), the Tax Court held that a transfer of a franchise to a new corporation by a 60% stockholder, in exchange for a 15-year installment note, was a sale rather than a non-taxable exchange. The court first rejected the government's argument that the note represented "equity" in the corporation, and then expressly held that it did not constitute a "security" under Section 351 of the 1954 Code, citing *Warren H. Brown*, *supra*. The following language from the court's opinion, (at p. 1739) is highly pertinent to the instant case: "The only investment Brook had in petitioner was his stock. Petitioner's installment obligation was not

intended to give Brook a continuing investment or stake in petitioner's business. On the contrary, the purpose of the contract was to liquidate, as quickly as was consistent with petitioner's business and financial exigencies, all of Brook's interest, other than arising in connection with his stock ownership, in petitioner's economic well-being. Therefore, petitioner's contractual obligation to pay Brook for the franchise is not a security within the meaning of Section 351."

The next decision of the Tax Court on this question, *Charles E. Curry*, 43 T.C. 667 (1965) is believed by appellant to be particularly well reasoned and persuasive authority. Strangely, although it was relied upon heavily by appellant, and cited *with approval* in the opinion below, the respective decisions of the Tax Court in *Curry* and the instant case are patently inconsistent.

In *Curry*, pursuant to an alleged contract of sale, four family members transferred income producing property to a corporation organized two days earlier, in which 55% of the stock was owned by two of the transferors and the remaining 45% was owned by the husband of a third transferor. The bulk of the purchase price was payable in installments over a period of 20 years, evidenced by two promissory notes secured by deeds of trust on the transferred property. As in the instant case, the government contended that the organization of the corporation and the sale of property to it were interdependent steps in a single transaction governed by Section 351. The government's primary position was that the notes received by the transferors were substantially equivalent to stock in the corporation. As an alternative, the government contended the notes constituted "securities" within the meaning of Section 351.

The court first rejected the contention that the notes represented stock and held that they created a bona fide

indebtedness, just as the court did in the instant case. A “cogent factor” supporting such result there, as it was here, was the *disproportion between stock ownership and note ownership*. The court said on page 687 of its opinion in *Curry*: “Consequently, upon final payment of the two notes, two of the original owners will have completely terminated their financial interests in the corporation and its property. Assuming that Charles F. and Charles E. retain their stock, they will have changed their positions significantly. Charles F. will have a much smaller interest, Charles E. a much larger one. *The substantial changes in ownership which are taking place as the notes are paid strongly support the contention of the petitioners that the transfer to the corporation was intended to and did constitute a sale of the property, and that the notes are representative of a bona fide indebtedness arising from such sale.*” (Emphasis added.)⁹

Having decided that the notes were not to be treated as stock for purposes of applying Section 351, the *Curry* court proceeded to consider the alternative argument that the notes were securities. The enormity of the Tax Court’s different treatment of the very same issue there, as compared with the instant case, can be seen by reading pages 696 and 697 of the *Curry* opinion. After citing several of the cases which have held that Section 351 and its predecessors did not apply to a bona fide sale, the court said (at p. 697): “The non-applicability of section 351 appears to have been assumed in all the cases cited in the preceding paragraph. This rule appears so well settled that we would not feel

⁹This quotation should be compared with an almost identical statement in the Opinion below citing *Curry*. [T. 136.] Inexplicably, however, the court below ignored the language in *Curry* that such changes in ownership indicate a *sale*—not merely that the notes represent a true indebtedness, as held here.

justified in overturning it even if we were convinced it be erroneous. However, we are not so convinced.

If respondent's position were adopted, Section 351 would apply even where an unrelated third party was the stockholder of the corporation. . . . We cannot believe that Congress intended non-recognition of gain in such a case. Indeed, respondent would undoubtedly be quick to object if taxpayers tried to prevent recognition by such a device. Yet it is clear that, in a sale effected in this manner, the transfers of cash for stock and property for notes are interdependent steps of a single plan. It is not a ground for distinction that two of the stockholders in the instant case were also transferors of realty, since we have found the parties were capable of independent action and intended a bona fide sale.

We have considered the cases cited by respondent, but they are factually distinguishable and are not controlling. *In view of our conclusion that section 351 does not apply to this sale, we find it unnecessary to consider petitioners' argument that the notes are not 'securities' as that term is used in section 351.*" (Emphasis added).

It is beyond appellant's understanding how the Tax Court managed to reach such a contrary result in the instant case on the corollary "security" issue after following *Curry* on the primary issue. The cases are indistinguishable in principle and the court certainly gave no hint that it thought otherwise. Yet, when the court moved on to the security point in this case, it simply ignored its holding and rationale in *Curry* and the other authorities cited hereinabove.

But the Tax Court's unexplained departure from *Curry* on the security issue in the instant case becomes even more of an enigma upon examination of its opinion

in *Stevens Pass, Inc.*, 48 T.C. 532 (1967), decided after this case. There, the issues and facts were in all material respects *identical* to those here. The taxpayer corporation purchased 100% of the stock of an old corporation and liquidated it claiming a stepped-up basis under Section 334(b)(2). Although the new corporation was formed to acquire the old one, there were substantial differences in stock ownership so that there was a shift in control as the result of the transaction. One owner of 50% of the voting stock in the old corporation owned no stock in the new one. The owner of the other 50% of the voting stock in the old corporation owned only 30% of the new corporation. A third individual, who had owned 100% of a second class of non-voting stock in the old corporation, became a 20% owner of the new corporation. The remaining 50% of the stock in the new corporation was purchased by outsiders. The new corporation gave a ten-year installment note for the purchase price.

Appellee argued there, as he did here, that the stepped-up basis should be denied because the transaction fell within the provisions of Section 351. Although not entirely clear from the court's opinion, it appears that the government argued only that the ten-year installment obligation constituted a "security." In any event, it was argued that the "control" requirement of Section 351 was satisfied by treating the outside investors who contributed cash as part of the "transferees" along with the stockholders of the old corporation. But the Tax Court, following *Charles E. Curry, supra*, held that the government's position "*requires an unwarranted extension of the scope of the non-recognition provisions of Section 351.*" *Stevens Pass, Inc., supra*, at 539. Pointing out the "strikingly similar" factual pattern of the *Curry* case, the court emphasized the significance of the substantial changes in stock owner-

ship; and it was noted that both cases unquestionably involved arm's length transactions (citing also this court's decision in *Murphy Logging Co. v. United States, supra*).

In view of the same findings in the instant case regarding the arm's length nature of the June 26, 1961 transaction, and the substantial changes in ownership, what conceivable justification is there for such disparate treatment here? Indeed, since the sellers here owned even less of an interest in appellant—less than 50%—than the sellers did in *Curry* and *Stevens Pass*, it requires even more of an “unwarranted extension” to apply Section 351.

The most recent decision by the Tax Court in this area, though reaching a different result on the facts, is not inconsistent with appellant's legal contentions in the instant case. In *George A. Nye*, 50 T.C. No. 21 (1968), two partners organized a corporation to take over their business and acquired all of its stock. At about the same time, they transferred their partnership assets to the corporation for a ten-year installment note. The court found that despite the form of the documentation used, the transaction was not a bona fide sale and in substance was a mere change in the organization of the enterprise. The promissory note was then held to qualify as a “security,” bringing the transaction within the purview of Section 351.

Of course, the point which conclusively distinguishes the case at bar is that here, unlike the finding in *Nye*, there was a substantial, recognized business purpose for the sale to be separate from the stock issuance. The uncontroverted purpose of the transaction was to effect a true sale—not a mere change in form—by transferring control and 70% ownership to new parties. As we have shown, this substantial shift in ownership, and

the disproportion between the noteholders and stock owners, was cited by the court in *Stevens Pass* as sufficient in and of itself to distinguish the type of situation in *Nye*; and the same "cogent factor" was decisive in *Charles E. Curry*. Plainly, the *Stevens Pass* and *Curry* cases are controlling here.¹⁰

D. The Authorities Relied Upon in the Opinion Below Do Not Support the Decision in the Instant Case, nor Can the Court's Rationale Withstand Logical Analysis Under the Settled Principles Discussed in the Preceding Portions of This Brief.

It should now be apparent that the Tax Court in the opinion below reached precisely the opposite conclusion from that required under the authorities discussed previously and the undisputed facts of this case. An analysis of the cases which the court relied upon will show that they are fully consistent with the principles we have discussed and do not justify any different result in the instant case than that which was reached in such cases as *Charles E. Curry, supra*, and *Stevens Pass, Inc., supra*.

To begin with, the court quoted from the case of *Wellington Fund, Inc.*, 4 T.C. 185, 189 (1944), which did not even involve the non-taxable exchange provisions of the Code. The question there was whether a 12-year note representing loans by the taxpayer corporation to another corporation, for working capital needs, dis-

¹⁰In view of the change of ownership in the instant case, the point is academic but appellant feels that the rationale for the determination in *Nye* that the transaction was not a sale conflicts with several decisions, including two by this court. In *Miller's Estate v. Commissioner, supra*, and *Murphy Logging Co. v. United States, supra*, it was held that similar sales of partnership businesses to corporations owned entirely by the partners did not come within the provisions of Section 351. To the same effect, see *Warren H. Brown, supra*, and *Ainsle Per-rault, supra*, decided by the Tax Court itself.

qualified taxpayer from treatment as a mutual investment company because of an excessive investment in "securities" of another corporation. It was held that the note was not a security because it represented a loan, not an investment in the business. In the context of the problem presented in *Wellington*, the language quoted was correct. But it most certainly cannot be taken to mean that in order to be excluded from the term "securities" under Section 351, an indebtedness must be in the nature of a temporary loan for working capital needs.

The "more recent" case of *Camp Wolters Enterprises, Inc.*, 22 T.C. 737 (1954), *aff'd*, 230 F. 2d 555 (5th Cir. 1956), at least, did involve an application of Section 112(b)(5) of the 1939 Code (now Section 351). There, notes were issued by a new corporation in exchange for a transfer of certain property from individuals who concurrently received all of the corporation's stock. The notes were issued to the shareholders in proportion to their stock interest. In all, there were 89 unsecured, non-negotiable notes payable in from five to nine years from the date of issuance. After an "over-all evaluation of the nature of the debt," the court held that the notes were securities under Section 112-(b)(5). It concluded the notes represented a stake in the business because the venture was risky and the notes were unsecured, stating (at p. 752): "It seems clear that the note holders were assuming a substantial risk of petitioner's enterprise, and on the date of issuance were inextricably and indefinitely tied up with the success of the venture, in some respects similar to stockholders."

By contrast, the trial court found in the instant case that the business acquired by appellant was well established with a good past earnings record and equally good prospects for the future. Accordingly, the court

rejected the government's contention that payment was at the risk of the venture, similar to a contribution of capital. [T. 130-131, 132-133.] Although there was certainly some risk involved on the part of the sellers, as there is in any deferred payment sale, it was a good one under the circumstances and quite dissimilar from an equity investment. *Charles E. Curry, supra* at 693.

It is also significant that the taxpayer apparently did not contend in the *Camp Wolters* case that the transaction was a sale. The documentation used referred to it as an "assignment." Hence, the court never discussed the differences between a sale and an exchange under Section 112(b)(5). In *Harry F. Shannon, supra*, that Tax Court distinguished the *Camp Wolters* case on the facts and then stated (at p. 718): "Moreover, as suggested above in discussing *Le Tulle*, the court, in *Camp Wolters*, did not suggest that where the facts demonstrated a sale, it would nevertheless be necessary to transpose them into a section 112(b)(5) and (c)(1) exchange. See *Sun Properties v. United States, supra*."

More important, however, is the fact that in *Camp Wolters* there was no disproportion between the note-holders and the stockholders *and no change in control or beneficial ownership* as the result of the transaction. Hence, that case, like *George A. Nye, supra*, is distinguishable from the instant case for the specific reasons stated in *Stevens Pass, Inc., supra*. *Charles E. Curry, supra*, requires the same distinction. Cf. *Hyman Berghash*, 43 T.C. 743 (1965), *aff'd*, 361 F. 2d 257 (2d Cir. 1966); *Estate of Ernest G. Howes, aff'd sub nom. Commissioner v. Johnson, supra*.

The final case relied upon by the court below for its holding that the notes in question were securities, is *Daniel H. Burnham*, 33 B.T.A. 147 (1935), *aff'd*, 86 F. 2d (7th Cir. 1936), *cert. denied*, 300 U.S. 683

(1937). There, the court held an exchange of 10 year notes for stock, in connection with the recapitalization of a corporation, constituted an exchange of "securities" for stock amounting to a reorganization. The court specifically distinguished cases involving sales—which, for the same reasons, distinguishes the present situation.

The trial court's lack of understanding of the real rationale behind the authorities it relied upon—not to mention its total disregard of the cases cited by appellant—was made abundantly clear by the manner in which it sought to apply various "criteria" to the facts in the instant case. For example, the court said that while not controlling, "the fact that the term of the note is for 15 years itself strongly supports our conclusion," stating that notes of shorter terms were held to be securities in *Burnham* and *Camp Wolters*. [T. 142] *But the term was as immaterial in those cases as it was in the instant case. It is the nature of the debt which is determinative, not the length of the obligation.* The Supreme Court expressly so held in *Le Tulle v. Scofield*, *supra*.

The trial court offered no reason why any particular length of term should be significant on this issue. Appellant wonders how the court would explain the cases in which it has held that notes of 15 years or more in duration were not securities. *e.g.*, *Harry F. Shannon*, *supra* (49 years); *Charles E. Curry*, *supra* (20 years); *Arthur F. Brook*, *supra* (15 years). See also, *Sun Properties, Inc. v. United States*, *supra* (15 years).¹¹

¹¹It should also be remembered that the court acknowledged the sound business judgment of selecting 15 year terms for the notes in question, instead of the 10 year pay-off initially proposed. [T. 130.] Apparently the reason for the particular term was not a factor in the trial court's thinking on this issue. Is it purely a matter of time, which some arbitrary dividing line? What shorter period would have made the difference here—and why?

The next of the trial court's "criteria" was that the notes, together with the Agreement of Purchase and Sale, secured for the Jerome Brothers partnership "the continuing participation in the business which is so characteristic of a security interest." [T. 142.] The court then discussed the various restrictive provisions of the agreement which it had previously said were merely designed to protect the Jeromes as creditors. [Compare T. 135-136 with T. 142-143.] It is obvious from the authorities we have discussed, that these protective measures (which all prudent deferred payment creditors demand in one form or another) are not the kind of "continued participation in the affairs of a business" referred to in *Le Tulle v. Scofield* and the other cases using that phrase. What is really meant is a substantial continued *proprietary* interest—a stake in the success of the venture—not the interest of a secured creditor in connection with an installment sale to the corporation. The "security interest" of a seller is not the same as that of a proprietor; and it is only the latter which is within the purview of Section 351. *Charles E. Curry, supra* at 692.

We refer again to our earlier quotations from the Tax Court's own decisions in *Warren H. Brown, supra*, at p. 36 and *Arthur F. Brook, supra*, at p. 1739. There, the court stated explicitly in each case that the purchasing corporation's installment obligation was not intended to give the seller a continuing investment or stake in the business. On the contrary, its purpose was to liquidate his interest as quickly as was consistent with the corporation's ability to pay. This is equally true in the present case.

The last criterion which the court referred to, is the fact that each of the three Jeromes continued to own 10% of the stock in appellant, and continued to actively participate in the management of the business. Here

again, the court missed the point. Many of the authorities we have discussed involved continued stock ownership and participation in the management of the business. In most of them, the noteholders even *controlled* the business. But such participation does not come from the note given by the corporation for the purchase price. It is not the type of continued participation through ownership of securities discussed by the cases. *Arthur F. Brook, supra*; cf. *Estate of Ernest G. Howes, supra*.¹²

One further point which should be mentioned in connection with this issue, is that the trial court's reliance on the various "step transaction" cases, cited in the opinion for the purpose of finding "control" by the transferors, cannot survive the initial misapplication of Section 351. Since the June 26, 1961 transaction was a bona fide sale, it cannot be converted into a Section 351 exchange merely because the sale and stock issuance were interrelated parts of a larger transaction. The court expressly so held in *Charles E. Curry, supra*, and *Stevens Pass, Inc., supra*. The point is, even in combination the various steps add up to a transaction which is not within the intended purview of Section 351.

The ultimate effect of the Tax Court's decision in the instant case, if permitted to stand, will be to so broaden the scope of Section 351 that it will effectively prohibit most long term sales to corporations organized for that purpose—even if, as in this case, they are controlled by someone other than the sellers—unless the corporate purchaser is willing to assume the seller's adjusted basis. No such tax disadvantage is imposed on

¹²As noted previously, the court also held in the instant case that the note received by the Wilson Co. was a security for the same reasons applicable to the Jeromes' note. However, the Wilson Co. did not acquire any stock ownership in appellant or participate in the management of appellant's business.

any other purchaser of property in an arm's length transaction, and it most assuredly was not the intention of Congress that Section 351 should have that effect in cases like this one.

II.

The Tax Court Erred in Holding That the Stock Purchased in the June 26, 1961 and December 20, 1962 Transactions Was Acquired From a Person Whose Stock Was Attributable to Appellant Under Section 318.

A. The Issue Here Is Whether Section 318 Was Properly Construed.

The court held that appellant was not entitled to a stepped-up basis upon the liquidation of Old Baker, Kerman and Veronica on the ground that the stock of those corporations was not "purchased" by appellant within the meaning of Section 334(b)(3)(C). This determination requires a review of the Tax Court's interpretation of Section 318 of the Internal Revenue Code, as applied to facts which are not in dispute. Unlike the first issue, however, the problem here seems to be one of first impression.

In order to make Section 334(b)(3)(C) applicable, the court had to find that on the dates of the 1961 and 1962 transactions the Jerome Brothers partnership owned 50% or more of appellant's stock. In such event, Section 318(a)(2)(C) would require appellant to be considered the owner of the stock which the Jerome Brothers partnership owned in Old Baker, Kerman and Veronica. The partnership, of course, owned none of appellant's stock directly but did own 30% constructively by reason of Section 318(a)(2)(A), which attributes to a partnership any stock owned by its partners.

To this 30% constructive ownership, the court added 16.5% by reason of its determination that Manchester, the limited partnership, was still in existence, at least for purposes of applying the partnership attribution rules of Section 318(a)(2)(A), as late as December 20, 1962. Thus, it concluded that the 10% of appellant's stock owned by each of the five keymen who had been partners in Manchester was attributable to Manchester, making it the constructive owner of 50% of appellant's stock. Each of the Jerome brothers was then deemed to own 11.11% of such 50%, or 5.5%, because he owned 11.11% of Manchester. And finally, the 5.5% of appellant's stock thus attributed to each of the Jeromes was attributed once more to the Jerome Brothers partnership, making the total of 16.5% derived from Manchester's alleged existence.

A final 5% of appellant's stock was deemed owned by the Jerome Brothers partnership in a similar three step application of the attribution rules from one of the other keymen, Jack Keith, through Keith Engineering partnership.

By combining the attribution rules in this fashion, the court determined that the Jerome Brothers partnership owned a fatal 51.5% of appellant's stock so that sections 318(a)(2)(C) and 334(b)(3)(C) must be applied to deny appellant's claim of a stepped-up basis.

B. After Manchester Sold Its Assets and Permanently Ceased Engaging in Business on March 1, 1961, It Terminated for Tax Purposes Under Section 708(b).

If, as appellant contends, Manchester terminated on March 1, 1961, the court erred in attributing 16.5% of appellant's stock to the Jerome Brothers partnership under the three step application of the partnership attribution rules of Section 318. The elimination of such attribution by way of Manchester, of course, would require a reversal on this issue.

Section 318 does not define the terms “partnership” or “partner,” nor does it say when an existing partnership ceases to be such for attribution purposes. In the instant case, the court found that Manchester, which was formed for a specific purpose, did in fact sell all of its assets connected with that venture on March 1, 1961; and that after such date the partnership “no longer engaged in active business.” [T. 114-115.] Nevertheless, the court concluded that it continued to exist for the purpose of “winding up its affairs”—*i.e.*, collecting money due the partnership by reason of the March 1 installment sale of its assets. In the court’s view, any partnership that is “winding up its affairs,” even though admittedly no longer in business, is still a “partnership” and Section 318 must be applied. [T. 152-154.]

However, for reasons unknown to appellant, the court does not appear to have considered the principal argument we advanced below that Manchester should not be treated as a partnership under Section 318 because it terminated for purposes of partnership taxation under Section 708(b) of the Internal Revenue Code. Of course, we realize that Section 708 expressly states that its rules are for purposes of partnership taxation under subchapter K, and hence do not necessarily apply to Section 318. Indeed, appellant believes that the differing purposes behind the two sections require a termination for constructive ownership purposes *sooner* than the technical termination date for filing partnership returns and winding up. In any event, it seems obvious that there is no rational basis for regarding a partnership as continuing under Section 318 *after* it has terminated for income tax purposes. The court below did not even discuss this argument or Section 708.

Section 708(b)(1)(A) provides that a partnership terminates if “no part of any business, financial op-

eration or venture of the partnership continues to be carried on by any of its partners in a partnership." Under Regulation Section 1.708-1(b), the partnership terminates under this provision "when operations of the partnership are discontinued." In commenting on the meaning of cessation of business under Section 708, *Mertens Law of Federal Income Taxation*, §35.75 states (at p. 214): "It would seem that the 'business' of the partnership includes only the activities for which it was originally established or which were undertaken in the course of its operations."

Since the trial court found that on March 1, 1961 Manchester sold the assets connected with the business for which it was established and thereafter did not engage in any business, Manchester clearly terminated under this provision. The court's statement that the partnership was still "winding up its affairs" is irrelevant. Under the regulations, a winding up period does not prolong the existence of the partnership after an agreed dissolution if the partners do not carry on any business during the winding up period. Reg. Sec. 1.708-1(b).¹³

Furthermore, and even more important, the sale of all of Manchester's assets by itself would automatically terminate the partnership under a separate provision of Section 708(b). Section 708(b)(1)(B) provides that there is a termination if there is a sale of 50% or more of the total interest in partnership capital and profits within a 12-month period. Regulation Section 1.708-1(b) provides that the date on which the partnership terminates in such event is the date of the sale.

¹³In any event, appellant does not understand the basis for the court's holding that Manchester was still winding up its affairs as late as December 20, 1962, the date of the Veronica transaction. Manchester's final tax return was for the period ending August 30, 1962.

This court has held that a sale of the principal partnership assets will be treated for tax purposes as a sale of the partnership interests. *Hatch's Estate v. Commissioner*, 198 F. 2d 26 (9th Cir. 1952). That decision was followed in *Barran v. Commissioner*, 334 F. 2d 58, 64-65 (5th Cir. 1964). It follows that the March 1, 1961 sale of all assets immediately terminated the partnership under Section 708(b)(1)(B). *James, et al. v. United States*, 63-1 U.S.T.C. ¶9478 (D.C. Ga. 1963).

The fact that a partnership tax return was filed for a subsequent period, ending August 31, 1962, does not constitute an admission that the partnership was in existence until that time, particularly where the only purpose for the return was to report the sale of the partnership's assets. *Hatch's Estate v. Commissioner, supra*; *Avent v. Commissioner*, 76 F. 2d 386 (5th Cir. 1935). Since the provisions of Section 708(b)(1)(B) apply automatically, the partnership's existence could not be extended beyond the date of the sale simply by filing a partnership tax return for a subsequent period. See, *James, et al. v. United States, supra*.

C. Since Under State Law the Agency Relationship Was Dissolved on March 1, 1961, Eliminating the Rationale for Partnership Attribution, Manchester Was No Longer a Partnership Within the Purview of Section 318.

Irrespective of whether Manchester terminated on March 1, 1961, under the technical provisions of Section 708(b), appellant contends that there was definitely a termination of the partnership on that date insofar as the purpose of Section 318 is concerned.

The underlying purpose of Section 318 is to prevent tax avoidance in situations involving possibly identical economic interests. The partnership attribution rules are based upon a kind of "alter ego" theory. Thus, stock actually owned by a partner is deemed owned by

his partnership because of the agency relationship between them. On the other hand, stock which is actually owned by a partnership is deemed owned by its partners in proportion to their interests in the partnership on the theory of *beneficial ownership*. See, *Mertens, Law of Federal Income Taxation*, Code Commentary, Ch. 1, Subch. C, pp. 114-127; Senate Committee Report on P. L. 88-554, 2 U.S. Cong. & Adm. News. '64, p. 3401.

It would seem obvious, therefore, that if the agency relationship and/or beneficial ownership terminate with respect to a particular partnership under controlling state law, there is no longer a partnership within the purview of Section 318. Under California law, a "dissolution" has precisely such legal effect. The rule may be stated as follows: "When a partnership is dissolved, the authority of one partner to create a new obligation or indebtedness for the partnership is revoked, and his agency for his co-partners ends." 38 Cal. Jur. 2d, Partnership, §107, pp. 22-23.

To the same effect, see *Credit Bureau, Inc. v. Beach*, 144 Cal. App. 2d 439, 443, 301 P. 2d 87 (1956); *Maryland Casualty Co. v. Little*, 102 Cal. App. 205, 211, 282 Pac. 968 (1929); *Rassaert v. Mensch*, 17 Cal. App. 637, 120 Pac. 1072 (1911).

A partnership may be dissolved under California law by mutual consent of the partners. It does not require a contemporaneous division of the assets, and results by agreement even though liquidation and winding up of the partnership's affairs are carried out subsequently. Nor does dissolution require formal action, but may be accomplished by words or acts implying an intent to dissolve, or by conduct which is inconsistent with the continuation of the partnership. *Middleton v. Newport*, 6 Cal. 2d 57, 56 P. 2d 508 (1936); *Pilch v. Milikin*, 200 Cal. App. 2d 212, 19 Cal. Rptr. 334 (1962); *Mc-*

Kenzie v. Dickinson, 43 Cal. 119 (1872); *Fooshe v. Sunshine*, 96 Cal. App. 2d 336, 215 P. 2d 66 (1950); *Fisher v. Fisher*, 83 Cal. App. 2d 357, 188 P. 2d 802 (1948); *Richards v. Plumbe*, 116 Cal. App. 2d 132, 253 P. 2d 126 (1953).¹⁴

In the instant case, the fact that the partnership sold all of its assets in connection with the only venture for which it had been formed, and ceased engaging in any further business whatsoever, is conclusive evidence of a dissolution in the absence of any showing to the contrary. *Maryland Casualty Co. v. Little*, *supra*; *cf. Cavasso v. Downey*, 45 Cal. App. 780, 188 Pac. 594 (1920). Since such dissolution terminated any agency relationship or beneficial ownership with respect to the subsequent stock issuance of appellant—a totally unrelated venture—there is absolutely no basis for regarding Manchester as a partnership for constructive ownership purposes after March 1, 1961, even if it was still in the process of winding up its affairs as the court concluded.

The Tax Court attempted to dispose of appellant's contention that Manchester could not be regarded as a partnership within the meaning and purpose of Section 318 after it sold its assets and ceased engaging in business, by simply citing a footnote from its own decision in *J. Milton Sorem*, 40 T.C. 206 (1963), *Rev'd on other grounds*, 334 F. 2d 275 (10th Cir. 1964). By such footnote, the court held that a partnership which

¹⁴Federal tax cases have also recognized that the existence of a partnership is a matter of the parties' intent. *Nellie Russo Linsenmeyer*, 25 T.C. 1126 (1956); *Leff v. Commissioner*, 235 F. 2d 439 (2d Cir. 1956).

“transacted no active business,” but admittedly continued in existence for the purpose of collecting and paying accounts incurred during business operations, required an application of the partnership attribution rules.

In the first place, appellant contends that *Sorem* is distinguishable from the instant case for several critical reasons. There, the taxpayer *admitted* that the partnership continued to exist past the crucial date. No contention was made that there was a termination under any of the provisions of Section 708, nor was it argued that there was a dissolution under state law. It was simply urged that the partnership should be disregarded because it transacted no active business, though it admittedly continued to collect and pay various accounts which had been created by business operations. In the instant case, the only “collection” activity which occurred after March 1, 1961 related to the proceeds of the sale of the partnership’s assets—the very event which terminated the partnership’s business—and had nothing to do with the former operations of the partnership.

Furthermore, in *Sorem*, stock in corporations owned by the partnership was sold to another corporation in which the partners owned a majority of the stock, and the acquiring corporation then carried on the same business. Hence, there was a *direct financial relationship* among the partnership, the individuals whose stock was being attributed by reason of its existence, and the corporation. By contrast, in the instant case, Manchester and the business it had carried on, had absolutely nothing to do with appellant or its business.

D. Even if Section 318 Could Be Considered Applicable to Manchester After March 1, 1961, Congress Did Not Intend That the Various Constructive Ownership Rules Be Compounded in the Manner Interpreted by the Tax Court.

As our final argument on the attribution question, we urge that even if Manchester could, for some purposes, be considered subject to the partnership attribution rules of Section 318 after March 1, 1961, those rules were misapplied by the court.

The statutory purpose behind Section 334(b)(3)-(C), in referring to Section 318, is to prevent possible tax avoidance by denying a stepped-up basis in all cases where a parent corporation purchased the stock of its subsidiary from the parent's own controlling stockholder. The rationale for this inflexible rule is that a controlling stockholder cannot deal at arm's length with his own corporation. Hence, the effect of the rule is to create a conclusive presumption that the transaction was not bona fide and, therefore, to deny it the same treatment accorded a bona fide transaction between unrelated parties dealing at arm's length.

If the Jerome Brothers partnership had owned 50% or more of appellant directly, there could be no question but that Section 334(b)(3)(C) would be applicable and its harsh presumption would have to be given effect—even though the court expressly found that the parties in fact dealt at arm's length and that the transaction was bona fide and the price was fair. [T. 131-132, 137.] But appellant does not believe Congress intended the rule to be extended to any situation where the seller does not actually own a controlling interest in the acquiring corporation and can only be deemed to own control through the application of another constructive ownership rule—*i.e.*, piling one conclusive presumption on top of another.

It is a certainty that Congress did not intend the type of multiple and compound attribution which the Court applied in this case. In 1964, Congress amended Section 318 to eliminate so-called sidewise or double attribution. Under Section 318(a)(5)(C), stock attributed to a partnership from one partner cannot be attributed out to other partners. The reason given by Congress for prohibiting a double application of the agency rule and beneficial ownership rule to the same stock, was that there was no economic basis for attributing one partner's stock to another partner. (See Senate Committee Report on P. L. 88-554, quoted in part *infra* in Appendix B.)

In the instant case, the connection between the actual owners and the constructive owners produced from the court's convoluted application of the various rules, is far more remote than that produced by mere double attribution. The court attributed appellant's stock actually owned by each of 5 unrelated keymen to Manchester, a partnership which had no business connection with appellant, then attributed the same stock out to the three Jeromes, and then attributed it again to the Jerome Brothers partnership. To this the court added a similar three step attribution of Keith's stock to the Jerome Brothers partnership.¹⁵ In effect, triple attribution involving three separate partnerships—all for

¹⁵With respect to the 1962 transaction, another fiction was also employed. The Veronica stock was acquired from the Jeromes as *individuals* and could not be attributed to appellant except in a roundabout fashion through attribution to the Jerome Brothers partnership. This is because no individual Jerome had as much as 50% of appellant's stock and their separate ownership could not be combined for Section 318 purposes. *Stevens Pass, Inc. supra*, at 539, n. 5 (dictum).

the purpose of applying still *another* constructive ownership rule that would conclusively presume appellant did not deal at arm's length with the Jeromes. An anomalous result indeed, in view of the court's express finding that the parties did deal at arm's length. This would mean the sum of the parts computed under the statute exceeds the whole.

While we recognize that the 1964 amendment does not purport to be retroactive, we feel that Congress' expressed reasons for the amendment establish beyond question that a literal application of the statute as originally enacted produces results which have no basis in the underlying purposes for the rules. In other words, the amendment was a clarification of Congressional intent. Surely, the statute must be interpreted to effectuate its true purpose, consistent with Congressional intent, and should not be used, as the court did here, to create a Frankenstein's monster which bears no relation to reality. In *Le Tulle v. Scofield, supra*, the Supreme Court refused to apply the reorganization sections literally when the result was not within the contemplated scope of the statute, and Sections 318 and 334(b)(3)(C) should receive the same construction.

The trial court's obdurate insistence that the statute must be applied literally, regardless of its admittedly "questionable philosophy" [T. 155], will produce an unconscionable injustice. As the result of what must, be termed a "mistake" by Congress, at the very least, in not recognizing potential abuses of the statutory purpose before 1964, appellant will be forced to suffer a totally unforeseen and devastating financial loss from

an absurd legal fiction which no longer exists. It is inconceivable that the courts are powerless to prevent such a miscarriage.

Conclusion.

For the foregoing reasons, the Judgment must be reversed.

Respectfully submitted,

HILL, FARRER & BURRILL,

GILLIN & SCOTT,

CARL A. STUTSMAN, JR.,

JACK R. WHITE,

GLENN M. ALPERSTEIN,

Attorneys for Appellant.







APPENDIX A.

Internal Revenue Code of 1954 (26 U.S.C.).

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK. (Prior to 1964 Amendment*)

(a) GENERAL RULE. For purposes of those provisions of this subchapter to which the rules contained are expressly made applicable—

* * *

(2) Partnerships, estates, trusts, and corporations.—

(A) Partnerships and estates.—Stock owned directly or indirectly, by or for a partnership or estate shall be considered as being owned proportionately by its partners or beneficiaries. Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as being owned by the partnership or estate.

* * *

(C) Corporations.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then—

* * *

(ii) such corporation shall be considered as owning the stock owned, directly or indirectly, by or for that person.

(4) Constructive ownership as actual ownership.—

(A) In general.—Except as provided in subparagraph (B), stock constructively owned by a person by reason of the application of paragraph (1), (2), or (3) shall, for purposes of applying paragraph (1), (2), or (3) be treated as actually owned by such person.

*Section 318 was amended by P.L. 88-554 §5(a), effective August 31, 1964.

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK. (After 1964 Amendment)

(a) GENERAL RULE. For purposes of those provisions of this subchapter to which the rules contained are expressly made applicable.—

* * *

(2) ATTRIBUTION FROM PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATIONS.—

(A) FROM PARTNERSHIPS AND ESTATES.—Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.

* * *

(3) ATTRIBUTION TO PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATIONS.—

(A) TO PARTNERSHIPS AND ESTATES.—Stock owned, directly or indirectly, by or for a partner or a beneficiary or an estate shall be considered as owned by the partnership or estate.

** *

(C) TO CORPORATIONS.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

* * *

(5) OPERATING RULES.—

(A) IN GENERAL.—Except as provided in subparagraphs (B) and (C), stock constructively owned by a person by reason of the application of paragraph (1), (2), or (4), shall for purposes of applying paragraphs (1), (2), (3), and (4), be considered as actually owned by such person.

* * *

(C) PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATIONS.—Stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of paragraph (3) shall not be considered as owned by it for purposes of applying paragraph (2) in order to make another the constructive owner of such stock.

* * *

SEC. 334 BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS.

* * *

(b) LIQUIDATIONS OF SUBSIDIARY.—

(1) IN GENERAL.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), then, except as provided in paragraph (2), the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor. If property is received by a corporation in a transfer to which section 332(c) applies, and if paragraph (2) of this subsection does not apply, then the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor.

(2) EXCEPTION.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), and if—

(A) the distribution is pursuant to a plan of liquidation adopted—

(i) on or after June 22, 1954, and

(ii) not more than 2 years after the date of transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and

(B) stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase (as defined in paragraph (3)) during a 12-month period beginning with the earlier of,

(i) the date of the first acquisition by purchase of such stock, or

(ii) if any of such stock was acquired in an acquisition which is a purchase within the meaning of the second sentence of paragraph (3), the date on which the distributee is first considered under section 318(a) as owning stock owned by the corporation from which such acquisition was made, then the basis of the property in the hands of the distributee shall be the adjusted basis of stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary or his delegate, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to a distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

(3) PURCHASE DEFINED.—For purposes of paragraph (2)(b), the term “purchase” means any acquisition of stock, but only if—

(A) the basis of the stock in the hands of the distributee is not determined (i) in whole or in part by reference to the adjusted basis of such stock in hands of the person from whom acquired, or (ii) under section 1014(a) (relating to property acquired from a decedent),

(B) The stock is not acquired from a person the which section 351 applies, and

(C) the stock is not acquired from a person the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock.

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) GENERAL RULE.—No gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

SEC. 708. CONTINUATION OF PARTNERSHIP.

(a) GENERAL RULE.—For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

(b) TERMINATION.—

(1) GENERAL RULE.—For purposes of subsection (a), a partnership shall be considered as terminated only if—

(A) no part of any business, financial operation, or venture of the partnership continues to

be carried on by any of its partners in a partnership, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

**Treasury Regulations on Income Tax — 1964 Code
(26 C.F.R.).**

SEC. 1.708-1. CONTINUATION OF PARTNERSHIP.

(a) GENERAL RULE. For purposes of subchapter K, chapter 1 of the Code, an existing partnership shall be considered as continuing if it is not terminated.

(b) TERMINATION —(1) GENERAL RULE.
(i) A partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. For example, on November 20, 1956, A and B, each of whom is a 20-percent partner in partnership ABC, sell their interests to C, who is a 60-percent partner. Since the business is no longer carried on by any of its partners in a partnership, the ABC partnership is terminated as of November 20, 1956. However, where partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30, 1957.

APPENDIX B.

Excerpt From Senate Committee Report on P. L.
88-554, 2 U.S. Cong. & Adm. News '64, p. 3401,
Amending Section 318.

"The operation of these two attribution rules together means for example, that stock of a corporation held by a partner is considered to be stock held by any partnership of which he is a member (agency rule). This stock which is considered to be held by the partnership, is then attributed (to the extent of his interest) to any other partner in the partnership (beneficial ownership rule). This double application of these rules has become known as sidewise attribution. . . .

"This double, or sidewise, attribution has the effect of attributing one person's stockholding to another even though there is neither an economic nor a family connection between the two persons. The effect of this sidewise attribution often is that a redeeming shareholder has 100 percent of the stock attributed to him and in no event will he be able to meet the requirements of the statutory provisions making it clear that the redemption is not a dividend.

. . . .

"Your committee concluded, since there is no basis either in family relationship or in common economic interest for the application of these two attribution rules at the same time, that sidewise attribution should be eliminated from the constructive ownership rules of present law. This is in accord with numerous recommendations of technical advisory groups which have concerned themselves with this problem.

"Your committee's amendment eliminates this sidewise attribution by providing that when stock is attributed to a partnership, estate, trust, or corporation from a partner, shareholder or beneficiary (agency rule), this stock is not again to be attributed to another partner, (beneficial ownership) rule. This is the only substantive change made in these rules."



Nos. 22,971 and 23,017

IN THE

FEB 6 1969

United States Court of Appeals

For the Ninth Circuit

BERTHA HECHT,

*Plaintiff, Appellee and
Appellant,*

VS.

HARRIS, UPHAM & Co., a partnership,
HARRIS, UPHAM & Co., INC., a corpora-
tion,

*Defendants, Appellants and
Appellees.*

*See this
Vol. (front)
for additional
pages.*

**REPLY BRIEF IN APPEAL No. 22,971
ON BEHALF OF DEFENDANTS**

EMANUEL BECKER,

40 Wall Street,

New York, N.Y. 10005,

THOMAS A. H. HARTWELL,

COOLEY, CROWLEY, GAITHER,

GODWARD, CASTRO & HUDDLESON,

The Alcoa Building, 1 Maritime Plaza,

San Francisco, California 94111,

Attorneys for Defendants

Harris, Upham & Co., et ano.

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WM. B. LUCK, CLERK

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Nos. 22,971 and 23,017

IN THE

**United States Court of Appeals
For the Ninth Circuit**

BERTHA HECHT,

*Plaintiff, Appellee and
Appellant,*

vs.

HARRIS, UPHAM & Co., a partnership,
HARRIS, UPHAM & Co., INC., a corpora-
tion,

*Defendants, Appellants and
Appellees.*

**REPLY BRIEF IN APPEAL No. 22,971
ON BEHALF OF DEFENDANTS**

INTRODUCTION

The court below found that Bertha Hecht misled Harris Upham (T. 1025). It did not find Harris Upham misled Bertha Hecht. But it awarded her more than one-half million dollars. It is with this anomaly that this appeal is mainly concerned.

Plaintiff's "closing brief" fails to explain why a finding of fraud is not necessary for a holding that Rule 10b-5 has been violated, nor does it explain how plaintiff can recover absent a finding that she was

misled by defendants to her damage. It fails to respond to our point that the court's finding of knowing acquiescence required judgment for defendants. Numerous cases, quotations and references are recited by plaintiff to dispute the finding of the court below of waiver, laches, and estoppel. None is apposite, and none affects the statement of this Court in *Royal Air Properties, Inc. v. Smith*, 312 F. 2d 210, 213, 224 (9 Cir. 1962).

The essence of laches, waiver, and estoppel is that plaintiff failed to act when she had an opportunity to act and to avoid the damage she now claims. *Bankers Trust Co. v. Pacific Employers Ins. Co.*, 282 F. 2d 106 (9 Cir. 1960), *cert. den.*, 368 U. S. 822 (1961):

"A claimant acts at his peril if by his own voluntary acts he creates a situation in which the responsible party is not only led to believe that he did no wrong, but also is duty bound not to take the only action whereby he could prevent the damages from piling up. This principle is particularly applicable to transactions in which one of the parties may be disposed to play a heads I win tails you lose game." (*James Wood General Trading Establishment v. Coc*, 297 F. 2d 651, 657 (2 Cir. 1961).

Any other view of the law would encourage the claim many plaintiffs have recently made after they had lost money in the market, "I was naive and did not know what I was doing," and for their lawyers to remind the courts that the Securities Acts are to be broadly interpreted to accomplish their purpose.

So far has this modern fashion for turning a broker into a surety gone, that a bank officer has claimed naivete and alleged "churning," *Weiser v. Schwartz*, CCH Fed. Sec. L. Rep., ¶ 92,286 (La. 1968). He successfully relied on the decision of the court below in the instant case.

THE FACTS¹

Based on the admissions of the plaintiff and her doctors and the testimony of two other witnesses (Faurey and Kresteller), the court below found that plaintiff knew what she was doing when she "very actively" traded securities and speculated in commodities. It also found that Mrs. Hecht knew her trading and speculation was contrary to her needs and circumstances and permitted them to continue. She knowingly assumed the risk. The supporting evidence is overwhelming and the findings clearly impelled (see pp. 9-21, 85, 86, 91 of our principal brief); plaintiff cannot establish that these findings are erroneous. Furthermore, the court did not find such trading and speculation contrary to her objectives; and contrary to the statement on page 13 of plaintiff's closing brief, there is no evidence that Mrs. Hecht was mentally deficient—quite the contrary (see page 85 of our principal brief).

The court failed to find confidence by Mrs. Hecht in Mr. Wilder. There is no evidence that Mrs. Hecht

¹Many of plaintiff's references fail to note that they are to her briefs rather than fact.

had trust and confidence in Wilder after 1956, despite plaintiff's claim on page 19 of her brief.² The court inferred in an area where inference should not be needed because the fact is subject to direct proof, that "the volume and frequency of the security trading was left to Wilder" (T. 1037). The finding is clearly erroneous. There is no evidence of Wilder's control over volume or frequency. The only evidence is that he recommended investment in almost all companies whose securities plaintiff purchased. But he made other recommendations which were not accepted. Nor is there any evidence that he recommended any particular purchase, or the amount thereof or of any sale or the amount thereof at any time. For example, Wilder may have recommended San Diego Imperial. The stock was purchased at various times and at various prices. There is nothing to suggest that any of the purchases other than the first were initiated by Wilder, or that even the amount of the first purchase was on his recommendation. If that were the fact the court would not need to rely on inference. Mrs. Hecht could have testified to it.

In support of the court's finding, plaintiff argues now, although she did not so testify at the trial, Wilder "initiated, solicited and recommended every one of the 1200-1400 securities transactions in plaintiff's account!" (p. 16). In fact, Mrs. Hecht held approximately 150 different securities during the

²Contrary to p. 19 of plaintiff's brief, Mrs. Hecht understood the nature of a trust account and that she would get the income thereof.

seven years, and made approximately 563 purchases (see addendum attached to plaintiff's closing brief). Sales at Wilder's recommendation are not alluded to in the entire record. Thus the only permissible inference is that Wilder recommended "buys" to a customer who talked to him one or more times a day, who critically reviewed her activities with him once a week, and who wanted "buys." It is not permissible to conclude from these facts that the "volume and frequency of the security trading was left to Wilder."

POINT I

THE DISTRICT COURT LACKED JURISDICTION; FRAUD WAS NOT PLEADED.

We pointed out in our principal brief that the district court lacked jurisdiction because there was no allegation in the complaint or in the pre-trial statement that plaintiff was misled.³ It serves no purpose to paraphrase statutes in pleadings and pre-trial statements and to point to these as plaintiff does on pp. 10 and 25 on its brief. Such allegations do not state the necessary jurisdictional facts, for "whether a federal question exists depends on the well pleaded allegations of the complaint." *Brown v. Bullock*, 294 F. 2d 415, 419 (2d Cir. 1961). Plaintiff did not plead facts constituting fraud; or participation or inducement by Harris Upham. Plaintiff

³Investments contrary to plaintiff's needs and objectives is not "fraud", as plaintiff's brief insists.

refers to briefs submitted to the court below after trial and to the record.⁴ These are not relevant.

We also pointed out in our principal brief that the court in its pre-trial order specifically stated that it “declined” to consider the jurisdictional question or the scope thereof. Our purpose was to establish that jurisdiction was raised sufficiently early so that the trial court should have ruled, and could not later, if federal law failed, rely on its pendant jurisdiction to make a determination based on state law. The district court did not in fact rely on pendant jurisdiction, but plaintiff does.

It is not clear whether plaintiff’s brief agrees or disagrees with the foregoing. She however claims, without record support, that the court gave us an opportunity to take the issue of jurisdiction to the Law and Motion Department. The court in fact refused us such an opportunity (hearing February 2, 1967, pp. 59, 60), or would such an opportunity have served a useful purpose, for the plaintiff’s pre-trial statement as much as the complaint defined the issue of jurisdiction. It could not have been determined by the Law and Motion Department, which would have necessarily left any issue arising out of plaintiff’s pre-trial statement to the pre-trial court. Conceivably the complaint, despite its insufficiency, might withstand a motion to dismiss, *Ellis v. Carter*, 291 F. 2d 270 (9 Cir. 1961), but surely not a pre-trial statement written and rewritten three times.

⁴She inaccurately asserts Wilder admitted he had “unlimited discretion” and that “the account was operated on a discretionary basis.” (pp. 10, 11.)

“Churning” Was Not Pleaded, Nor Was “Excessive” Trading Alleged to Have Misled.

Plaintiff followed some of the language of Rule 15c1-7 and alleged in the complaint that the trading in her security account was at an “excessive rate and frequency in view of the financial resources and character of the accounts” (T. 5), but she did not especially claim damage resulting therefrom. Her commodity trading was not alleged to be excessive, only inappropriate and as having been “induced.” In her pre-trial statement plaintiff abandoned her claim of excessive trading of securities and substituted therefor “excessive” trading of securities and commodities for the “character” of the account and plaintiff’s “needs and objectives.” This is not a violation of any law. Again damage was not associated with this allegation alone. In neither document did the plaintiff allege that she had been misled by this activity. For this reason we claimed that the court had no jurisdiction and under Fed. R. Civ. P. 12(h) the complaint should have been dismissed at pre-trial.

Plaintiff’s response does not pinpoint the complaint or the pre-trial statement, but refers to briefs and testimony, and claims such allegations are a statement of fraud even in a pre-trial statement. As we have noted in our principal brief, the statute is to the contrary; all judicial determinations hold excessive trading is not necessarily a fraud, and fraud is a necessary allegation to invoke Rule 10b-5. There are decisions that have held excessive trading for the character of an account may work a fraud. But

fraud must be alleged and proved. See *Moscarelli v. A. L. Stamm*, 288 F. Supp. 453, 457-58 (E.D.N.Y. 1968); *Lorenz v. Watson*, 258 F. Supp. 724, 730-31 (E.D. Pa. 1966); *Leonard v. Colton*, CCH Fed. Sec. L. Rep. ¶ 92,284 (E.D.N.Y. 1968).⁵ No court has held that such activity is automatically misleading. Plaintiff must allege and prove she was in fact deceived, and suffered damage by reason thereof.

The SEC cases cited by plaintiff on pp. 43 and 44 of her brief do not differ. Many of them do not deal with Rule 10b-5. They deal with violations of NASD rules where "suitability" is the issue and fraud need not be found (see, for example, *First Securities Corporation*, SEC Securities Exchange Act, Release No. 6497, March 20, 1961). In all cases of 10(b) violation the Commission had evidence that persons were or might have been misled—that a fraudulent practice consisting of more than excessive trading was involved.

We do not think it necessary to discuss the remarkable claims or intimations of the plaintiff that jurisdiction of subject matter is a question of fact to be determined by a trial court and is not appealable.

⁵*Newkirk v. Hayden Stone & Co.*, CCH Fed. Sec. L. Rep. ¶ 91,621 (S.D. Cal. 1965) was decided under Rule 15c1-7.

POINT II

THE COURT DID NOT MAKE THE NECESSARY FINDINGS FOR THE CONCLUSION THAT PLAINTIFF'S ACCOUNT WAS "CHURNED."

The Facts Found.

If one were to adopt the views of Judge Friendly in *Mamiye Bros. v. Barber Steamship Line, Inc.*, 360 F. 2d 774, 776, 777 (1966), the court's finding of churning would be reviewable without regard to the "clearly erroneous" rule because it is a multifaceted question involving law, fact, and the applicability of the law to the facts. But we need not press this view. The fundamental is that churning is essentially a new term in the legal literature, and its use is not illuminating unless the decision recites all facts relevant or at least necessary to the conclusion or the term is clearly defined. Absent definition or clear explication of fact, it is a label to indicate disapproval and liability. The court below did not find sufficient fact by any known standard, and specifically eschewed definition. It failed to relate the term to any statutory mandate. We therefore leave to this court without further discussion whether the finding of "churning" by the court below was "clearly erroneous," whether the court erred as a matter of law, or both.

The Court's Conception of Churning.

In so far as we have been able to determine (plaintiff's brief appears to agree with this conclusion), the court below believed that "churning" could be found even if trading in the account was not excessive in size or frequency for the "financial re-

sources and character" of the account (Rule 15c-1-7) and plaintiff was not misled to her damage by such trading. Departing from all tradition, it appears to have held that only a broker's motive needs to be proved; whether motive led to conduct deserving condemnation and damage need not be found to conclude there was "churning." No finding that the account was excessively traded as a trading account is needed, and damages may be found for all trading. Furthermore, even if plaintiff knew she had a trading account and that it was contrary to her needs and circumstances, the trading may be described as "churning" because the account did not meet the customer's "needs and circumstances." Since trading accounts rarely do, most trading accounts are now presumably subject to judicial review.

No other interpretation of the court's decision appears to be consistent with the opinion and the facts. The court did not find Mrs. Hecht wanted an investment account, nor did it intimate that she left the character of the account to Wilder. It did not have before it evidence that Mrs. Hecht's account was excessively traded as a trading account, and it could not arrive at such a conclusion without the benefit of expert testimony. The witness Wentworth testified that commissions were high, not for a trading account, which Mrs. Hecht knowingly had, but for an investment account, which she knew she did not have.

Because plaintiff realizes that she cannot support the claim that her account was excessively traded,

by standards of a trading account, she redefines a trading account "to efforts to improve the investment quality of her portfolio and to secure higher income yields from it" (page 49). But such redefinition does not help her because the court found that she knew and understood that she was "very" actively trading securities, including non "blue chips," and had assumed the risks of both.

Excessive Trading Is Not Necessarily Fraudulent.

Plaintiff claims on pages 38 to 40 of her brief that the Securities Exchange Act was intended to cover all manner of fraud with respect to securities. We agree; but in a civil action for damages such a fraud must actually mislead the plaintiff to her damage. It further claims that "deception is inherent in a claim of churning" and cites three cases on page 40 (see contra *Loss*, Securities Regulation 1481 (1962)). As we have noted on p. 8, *supra*, none of them support that conclusion. Active trading may be precisely the activity the customer wanted. See *In re Thomson & McKinnon*, 35 SEC 451 (1953); *In re Walter S. Grubbs*, 28 SEC 323 (1948). Failure to "comprehend" the risk was not deemed relevant in these two decisions of the Commission, perhaps because the risk is well known. Millions of people in the past believed and presently believe that active trading is the way to make money. Some of them have justified their confidence. All of them were and are privileged to try. For that reason, among many others, "excessive trading" cannot be "inherently" a fraud.

Non-Disclosure and Reliance.

Plaintiff argues that the court found non-disclosure. Aside from the fact that the court did not find reliance, the non-disclosure it found related to events in 1963 long after Mrs. Hecht ceased to trade.

The cases cited on pages 41 through 44 of plaintiff's brief decided by courts and the Securities & Exchange Commission with respect to violations of Rule 10b-5, NASD Rules, and Section 17(a) of the Securities Act, do not contradict the basic common-law principle for which we contend: In order to claim damages a person must be misled to his or her damage. Obviously in a disciplinary proceeding brought against a broker by the NASD or by the Securities & Exchange Commission, the sole concern of these bodies is whether the activity might mislead. They are not particularly concerned with how successful the broker's activities were. Furthermore, as we have previously pointed out, none of the cases which found a violation of 10b-5 relied on excessive trading alone. In each instance there was evidence of a customer misled by supporting activities and of a customer's confidence falsely induced by the broker.

Defendants' Duty Vis-a-Vis Mrs. Hecht's Account.

Plaintiff's brief asserts that defendant was required to treat Mrs. Hecht's account as an investment account, regardless of her wishes. It relies on the fact that her account was an investment account for a period of years at Walston & Co. It ignores the

fact that for many years Mrs. Hecht had a trading account at Walston & Co. and that between the time she left Walston and came to Harris Upham, she had a trading account at Hooker & Fay, another brokerage firm of which Mr. Wilder was a partner.

POINT III

THE COURT'S JURISDICTION OVER COMMODITY TRANSACTIONS AND THE CLAIM THAT COMMODITIES WERE "CHURNED."

Plaintiff's closing brief does not defend the court's finding that her commodity account was "churned." There is no evidence in the record from which that conclusion could be inferred. Indeed that finding supports our claim the court did not properly conceive churning even in securities. Nor does it defend the court's finding that excessive trading in commodities is excessive trading in securities and a violation of Rule 10b-5. It does, however, deal with the subject of federal jurisdiction over commodities transactions, and while this would appear to be irrelevant in view of the fact that no fraud was found with respect to commodities, and no churning could be found, we nevertheless treat with plaintiff's claims.

Jurisdiction Over Commodities

In *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359 (S.D.N.Y. 1966), the court held stealing from a securities account comes

within federal jurisdiction.⁶ In *Sinva* the stealing consisted of unauthorized transfers from a securities account to a commodities account and unauthorized transactions in commodities. If the money had been transferred to the broker's pocket or into real estate, the same result would have been reached. Therefore *Sinva* does not hold that commodity trading comes within the Securities Exchange Act or that a court has pendant jurisdiction over commodities. In fact, *Sinva* specifically held that commodities are not securities within the act.

In *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967), a single fraudulent scheme with respect to commodities and securities was alleged and the court held it had jurisdiction—presumably pendant jurisdiction—over the entire fraudulent scheme.

In *Errion v. Connell*, 236 F. 2d 447 (9 Cir. 1956), this court held that a single fraudulent scheme involving both securities and non-securities and encompassing the “same set of facts” would as a matter of sound judgment be adjudicated in a single federal action.

To come within the scope of these decisions, the plaintiff now claims there was a single fraudulent scheme. The court did not find such a single fraudulent scheme; it did not find fraud. It found that Wilder wanted to make commissions and that he

⁶We do not discuss at this time whether conversion comes within the Securities Exchange Act. There are some decisions which appear so to hold. No doubt conversions arising out of fraud would come within the Act, but theft without the aid of misrepresentation or its equivalent probably would not be within the language of the Act.

traded commodities to make commissions. The making of commissions is not a fraudulent scheme; every broker earns his living that way, and his customers well know the fact. Mrs. Hecht did. Furthermore, to come within the scope of a court's pendant jurisdiction, the "same set of facts" must encompass both claims. The activities in securities and commodities were at most parallel, not the same. Indeed, a major fact found by the court, that Wilder induced Mrs. Hecht to engage in trading commodities, took place before the account came to Harris Upham.

"Commodity Enterprises."

A number of recent decisions have held that when a customer has a commodity account with her broker in some arrangement comparable to a corporate enterprise or a syndication, and the broker issues a piece of paper at the opening of or during such an enterprise, that piece of paper constitutes a security. See pages 32 and 33 of plaintiff's closing brief. With that in mind plaintiff incorrectly credits Wilder on pp. 10 and 11 of the Closing Brief with "unlimited discretion." We consider *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946) is to the contrary, and the findings of fact of the court below are insufficient to make these cases apposite. Furthermore, any action would have to be based on fraud in the issuance of the security, not in mismanagement of the account.

The Commodity Exchange Act.

Whether the Commodity Exchange Act is enforceable in a private action is surely doubtful. See *Rosee*

v. Chicago Board of Trade, 311 F. 2d 524 (7 Cir. 1963). But we need not consider it here. The commodity Exchange Act would not help the plaintiff's cause, because the Act only prohibits fraud and deceit as those terms were commonly understood at common law. The court below did not find fraud or deceit.

Corrections of Plaintiff's Closing Brief.

Plaintiff's brief incorrectly states that securities were sold to finance commodity trading (page 30). There is nothing in the record to sustain this statement; plaintiff's record references in her brief do not sustain it.

Plaintiff's brief incorrectly states that Wilder "commingled" the two accounts in his "false" summary intended to represent Mrs. Hecht's over-all investment picture. These summaries were without the authority or knowledge of Harris Upham. They separately stated securities and commodities.

"Selective closeouts" now claimed by plaintiff for the first time as a fraud were not proved, as there is no evidence that Mrs. Hecht did not approve them.

POINT IV

ESTOPPEL, WAIVER, AND LACHES.

It would appear to be almost unnecessary to discuss the issue of estoppel, waiver and laches for where there is no misrepresentation or ignorance of fact in the first place there is no wrong. The Securities Acts do not apply to him who continues after he "has lost

his innocence" regardless of whether he "waits to see how his investment turns out."

Plaintiff's brief apparently recognizes that the court's findings of plaintiff's knowledge if permitted to stand requires dismissal of the complaint. It states the court's decision was a compromise (p. 60), but fails to appreciate that the compromise was a violation of law, and the complaint should have been dismissed. Losses resulting from risks assumed, as the court found, are not recoverable, and neither are losses which would not have occurred if plaintiff had spoken up.

Plaintiff responds to all of this with a large variety of citations essentially to prove that the doctrines of laches, waiver and estoppel do not exist. The cases deal with the following subjects: enforcement of illegal contracts, the Minimum Wage Law, actions for conversion, actions for patent infringement and for land title where notice of title existed in the usual form, tax decisions, and even criminal proceedings.⁷ None of them are apposite to the facts in this case or diminish the force of *Royal Air Properties, Inc. v. Smith*, 312 F. 2d 210 (9 Cir. 1962). Perhaps more to the point is that the court's findings meet all the legal standards recited by the plaintiff, and these findings are impelled by the evidence. Plaintiff knew—because she so testified—that she wanted her account to continue in blue chips and not to be traded, and the con-

⁷Contrary to plaintiff's statement, waiver does not require detriment. *Royal Air Properties v. Smith*, 333 F. 2d 568 (9 Cir. 1964). *Caterpillar Tractor Co. v. Collins Machinery Co.*, 286 F. 2d 446 (9 Cir. 1960) cited by plaintiff does not hold otherwise.

trary was taking place. Plaintiff knew that her account was being very actively traded even before she came to Harris Upham. She felt insecure and knew the risk of loss. The court may have found Mrs. Hecht to be "unsophisticated" and not a business woman, socially maladjusted and erratic.⁸ But that did not interfere with her knowledge of market gained over 30 to 40 years, or with her ever present suspicions. She acquiesced and led Harris Upham to believe she was satisfied. She may not have understood commodities. We think otherwise.⁹ But she knew that she was speculating in commodities and she knew the cost. There is no relief from bad or unsuccessful judgment freely exercised. See *In re Thomson & McKinnon*, 35 SEC 451 (1953), *In re Walter S. Grubbs*, 28 SEC 323 (1948), and cases cited on p. 46 of our principal brief.

Harris Upham continued to buy and sell securities for her in reliance on the fact that this is what Mrs. Hecht wanted.¹⁰ It did not buy in her positions and limit its loss as it would have done if her purchases and sales were not authorized. Mrs. Hecht never complained to Mr. Wilder or to Harris Upham about trading. She complained to Wilder only about losses.

⁸We are not privy to the facts before the Court during 1957-64. We did not know of her doctors.

⁹Neither we nor the court below knows. Mrs. Hecht's insistence on prevarication makes all attempt at appraisal surmise.

¹⁰Even if Mrs. Hecht did not not deliberately mislead Harris Upham she would be estopped. *Sidebotham v. Robinson*, 216 F. 2d 816, 829 (9 Cir. 1954). We express no opinion as to whether she did deliberately mislead; we believe Mrs. Hecht always wanted to trade.

Now she would like to get her securities, her money and commissions back as if she had never traded.

If the doctrines of waiver, estoppel, and laches are doctrines of elementary decency and morality, then plaintiff's claim must fail. *Royal Air Properties, Inc. v. Smith*, 312 F. 2d 210, 213-14 (9 Cir. 1962) and *James Wood General Trading Establishment v. Coe*, 297 F. 2d 651, 657 (2 Cir. 1961).

Any theory that would permit a plaintiff to let losses accrue before she complains is cynical and second guessing. Even if "Mrs. Hecht owed no obligation or duty to defendants to inform them as to how they should best handle her account to meet her investment requirements" as plaintiff states on page 66 of her brief, if she did not express dissatisfaction when she knew they were not meeting her attorney's now claimed investment requirements, she alone must bear the loss. This is what we understand to be the doctrine of this court in *Bankers Trust Co. v. Pacific Employers Insurance Co.*, 282 F. 2d 106, 111 (9 Cir. 1960) *cert. den.* 368 U.S. 822 (1961).

POINT V

THE LIABILITY OF HARRIS UPHAM.

No law, regulation or practice required supervision of commodity accounts during the period in issue. The court's finding of lack of supervision is without legal support.

The court below found liability on the ground that Harris Upham "indirectly induced" the acts consti-

tuting the violation of Rule 10b-5 (the language of Section 20(a) of the Securities Exchange Act). It also found that lack of supervision or inadequate supervision constitutes "participation" and "bad faith." These findings are conclusory, and make no reference to any fact which would evidence inducement, participation, or bad faith other than that Wilder, like every broker, was paid in part according to his production. This is not proof of inducement to act improperly. The only other fact noted by the court is that the managing partner of Harris Upham in the San Francisco office did not personally meet Mrs. Hecht. There is no provision anywhere which requires a partner to meet a customer. He must satisfy himself that his registered representatives know their customers, but this does not advance plaintiff's cause, for she agrees that Wilder knew her well.

If Harris Upham had no supervision, it would be unnecessary for the court to specify the deficiencies of its supervision. The court might have been able to find, if that is the law, that complete lack of supervision constitutes bad faith. But since there was supervision, the court was called upon to specify in what way it was so lacking as to constitute indirect participation, inducement or bad faith, for surely there is a difference between these and negligence or poor judgment.

SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833, 866-68 (2 Cir. 1968).

Nor should the court have judged our supervision in the "bright gleam of hindsight".

The court offered no specification of our supervisory inadequacy, and plaintiff's brief criticizes our failure to specify what supervision was exercised. We therefore call attention to the fact that the managing partner of our San Francisco office reviewed Mrs. Hecht's account every month for "churning," (R. 714-717, 735 et seq.) and that each of Mrs. Hecht's purchases of over-the-counter securities was reviewed by either the partner or by one of his managers (R. 713, 740, 741).

If Mrs. Hecht's account had been found by the court to have been excessively traded by standards of a trading account, then Mr. Mejia's (Harris Upham's San Francisco partner) failure to discover so obvious a fact could well be a subject of criticism. But the court did not find excessive trading by trading account standards. Nor did the court relate excessive trading to the objectives of Mrs. Hecht. It could not do so because Mrs. Hecht had either determined in the first place, or had agreed before she came to Harris Upham to engage in a trading and margin account. It presumably found excessive trading for the needs and circumstances of Mrs. Hecht, thereby relating Mr. Mejia's lack of supervision to his lack of personal knowledge of Mrs. Hecht's affairs which he was not required to have. Thus the court's finding of inadequate supervision, again without the benefit of expertise, is unsupported, and in that respect clearly erroneous.

Ratification.

The doctrine of ratification is inapposite. The court made no finding of ratification by Harris Upham and none would be warranted.

The cases plaintiff cites deal principally with ostensible authority, and do not hold that there can be ratification by the principal without full knowledge of the impropriety sought to be ratified—*Promis v. Duke*, 208 Cal. 420, 281 Pac. 613 (1929), or a deliberate refusal on the part of the principal to investigate facts brought to the principal's attention of an agent's unauthorized activity with resultant injury because of such refusal,

Compare *Reusche v. California Pacific Title Ins. Co.*, 231 Cal. App. 2d 731 (1965), 42 Cal. Rptr. 262;

Hutchinson Co. v. Gould, 180 Cal. 356, 181 Pac. 651,

unless there is a deliberate, unequivocal announcement of ratification by the principal with some but less than complete knowledge of all the facts.

Volandri v. Hlobil, 170 Cal. App. 2d 656, 339 Pac. 2d 218.

In addition, for the doctrine of ratification to apply the person performing the act must at the time have professed to be acting as the agent of another.

Puget Sound Lumber Co. v. Krug, 89 Cal. 237, 26 Pac. 902;

Schultz v. McLean, 93 Cal. 329, 28 Pac. 1053;
Restatement of Agency, § 85.

Harris Upham cannot be charged with having ratified any inducement of Wilder to have Mrs. Hecht enter the commodities market, which occurred if at all while Wilder was a partner of Hooker & Fay and under circumstances of which Harris Upham had no knowledge.

As for Itek and Colonial, these were private transactions between Wilder and Mrs. Hecht of which Harris Upham had no knowledge. Moreover Wilder did not profess to be acting for anyone other than himself in connection with the Colonial transaction, or when the Itek stock was acquired from Mrs. Hecht. Mrs. Hecht knew he was not acting for Harris Upham.

Respondeat Superior.

Plaintiff has found no authority to support her conclusion that "respondeat superior" is applicable to an action under Section 10(b). *Myzel v. Fields*, 386 F. 2d 718, 738 (8 Cir. 1967), *cert. den.* 390 U.S. 951 (1968), quoted by plaintiff on page 59 in her brief, does not hold it is applicable. *Kamen & Co. v. Paul H. Aschkar & Co.*, 382 F. 2d 689 (9 Cir. 1967), *cert. granted* 390 U.S. 942 (1968) would appear to be to the contrary. See also *Moscarella v. A. L. Stamm*, 288 F. Supp. 453 (E.D.N.Y. 1968).

POINT VI

THE STATUTE OF LIMITATIONS.

In *Moviecolor Ltd. v. Eastman Kodak Co.*, 288 F. 2d 80, 87 (2 Cir. 1961), the court took for granted that under federal law a finding of "fraud" does not toll the Statute of Limitations unless there is an element of concealment. Improper conduct does not toll the statute even though it may be regarded a constructive or statutory fraud. The court below and the plaintiff in her brief have failed to point to a fact concealed.

There is no evidence, nor is it a fact, as plaintiff contends, that Mrs. Hecht's fears were lulled by Wilder's memoranda. The court found that Mr. Wilder sought to allay her concern in one memorandum, but not that they were in fact allayed. The court did not make this finding, because Mrs. Hecht testified that her fears were not allayed, and she did not read any of Wilder's memoranda.

Plaintiff argues that churning is a continuous offense and the statute does not begin to run until completed. Presumably liability does not accrue until terminated. The argument is not meaningful in the context of this case. The cases she cites on page 70 do not support her claim. Furthermore her account was not actively traded after 1961.

Plaintiff cites *Holmberg v. Armbrrecht*, 327 U. S. 392, 397 (1946) to prove that concealment tolls the Statute. In that case there was non-disclosure, and surely when facts are concealed, the statute cannot be permitted to run. We have never otherwise suggested.

Plaintiff claims that she could not discover the facts because Mr. Wilder picked up her papers. Wilder picked up her papers as her employee, and at her request. Furthermore, she had her tax returns and knew she lost money in 1962.

Plaintiff also argues:

1. Mrs. Hecht's mental condition gives her special status in so far as the running of the Statute.

The court failed to find she had a mental condition, and the law is to the contrary. See *Azalea Meats, Inc. v. Muscat*, 386 F. 2d 5, 9 (5 Cir. 1967), cited by plaintiff, and cases cited in our principal brief, page 66.

2. A fiduciary relationship lessens the need to investigate.

We agree when the "fiduciary relationship" is one of actual confidence and not one of suspicion, fear, and disbelief there is less need to investigate. But a "fiduciary relationship," whatever its meaning, does not permit playing "I win you lose."

5. A fiduciary relationship may continue even where there is open hostility (see footnote 44 on page 74 of plaintiff's brief).

No doubt this is the law when the fiduciary relationship is one that cannot be terminated at will. Until a lawyer withdraws he must honor his commitments. Plaintiff was not in the position of a client.

POINT VII

THE ITEK AND COLONIAL TRANSACTIONS.

The Admission of Evidence Against Harris Upham.

On page 21 of her brief, plaintiff refers to the ruling of the court that all matters preceding 1957 would not be binding on the defendant unless and until the court should otherwise rule. Plaintiff then proceeds to argue that this was not a final ruling and therefore defendant was called upon to cross-examine Mrs. Hecht after she had testified with respect to the Itek and Colonial transactions.

The legal argument is wrong; the references to the record are intended to mislead. The Itek and Colonial transactions were separately ruled out by the court on ten separate occasions, and the court acquiesced in our statement that since the court had not admitted the evidence against Harris Upham, there would be no point in cross-examining with respect to these transactions.

The circumstances following the court's ruling are here stated because plaintiff attempts to confuse them. On October 20, 1967, the court called counsel together and read portions of its draft of opinion. At that time we called its attention to the fact that these transactions had not been admitted against Harris Upham. The court agreed that if it were to admit them, an opportunity would have to be given for opposing proof. But it decided the case and proposed to give us such an opportunity after decision. Nothing was said in the opinion about pre-trial discovery. We did not offer proof; it was too late. Wilder had been dis-

charged for privately dealing with a customer contrary to stock exchange regulation. Another witness was dead. Mrs. Hecht could not be successfully cross-examined after the court had held she did not know what she was doing as to Colonial. Contrary to plaintiff's statement, we did not waive the objection to prejudgment and the court did not warn us that we would waive. We came to court to make motions with respect to pre-judgment, Statute of Limitations, and the like, and to offer in evidence a document showing that Wilder had no authority to act on behalf of Harris Upham or privately to engage in dealings with customers. Plaintiff cites no authority to support her theory of waiver. It would be extraordinary if the court's pre-judgment were waived at the very time a motion is made to vacate judgment for that very reason.

The Statute of Limitations.

Plaintiff's caption for Point VII A 1 (p. 75 of her closing brief) states that her "pleadings encompassed the transactions" but she cannot point to a single allegation of her complaint or pre-trial statements which would indicate that such transactions were encompassed. She points instead to the trial memorandum of fact filed on June 6, 1967, more than three months after the Statute of Limitations by any computation had expired.

Plaintiff implicitly admits that the complaint does not allege the Colonial transaction. She excuses that on the ground that these facts were "pieced" together

by her counsel on the weekend preceding June 5, 1967. Mrs. Hecht testified that she suddenly "remembered it because it was not in the ledger" (R. 3590, 91). Therefore she knew the facts as of the time they occurred, and any claim with regard thereto was barred long before she instituted action.

There are citations in plaintiff's brief on the subject of amending complaints, but none of them come to grips with the decision of this court in *Firchau v. Diamond National Corporation*, 345 F. 2d 260 (9 Cir. 1965).

Supervision, "Participation," and Defendants' Alleged Knowledge.

Plaintiff's claim of lack of supervision regarding these transactions is hopelessly at odds with the simple realities. There is no method by which Harris Upham could have supervised private transactions between Mrs. Hecht and Mr. Wilder, and more particularly with respect to securities that were not purchased through Harris Upham (Colonial) or were delivered out by Harris Upham to Mrs. Hecht (Itek). Conceivably the Securities Exchange Act, if apposite, requires "internal" supervision, not external supervision.

Whether or not these securities were sold through Harris Upham is really not in point. There is no evidence the certificates were in the name of Mrs. Hecht at the time they were sold, and Harris Upham had no way of knowing that any of the shares of stock sold had originated with Mrs. Hecht.

Plaintiff's recitation of the facts with respect to the participation of Mr. George U. Harris (on page 82) simply distorts the record. Mr. Harris' deposition which plaintiff cites, makes clear Mr. Harris was not aware of the facts except as furnished to him by counsel at the time he gave deposition (deposition of George U. Harris, pp. 14, 47-49).

Wilder's Authority.

In her caption for Point VII E plaintiff states "Harris Upham & Company is also liable because Mr. Wilder acted within the scope of his employment." The argument that follows deals only with ostensible authority. The court did not find ostensible authority. Mrs. Hecht did not testify that she understood she was dealing with Harris Upham in connection with these transactions. She accepted Wilder's bank check for her Itek stock. She bought the Colonial stock privately.

POINT VIII DAMAGES.

Plaintiff asks recovery on the theory of loss of bargain, a doctrine essentially contrary to the federal rule of damages which limits recovery to actual loss. While damages are determined by federal law we note that California law is in accord. *Gagne v. Bertran*, 43 Cal. 2d 481, 275 Pac. 2d 15. Another difficulty with plaintiff's thesis is that she made no bargain that was breached after May 1, 1957, and the court did not find she had made a bargain before that.

Plaintiff argues that the court may adopt any reasonable means of computing the extent of damages. But the damages must be attributable to the wrong found by the court. Proximate cause must be found. *Story Parchment Co. v. Paterson Parchment Paper Co.*, 282 U. S. 555, 562-63 (1931). It may not be guessed. *James Wood General Trading Establishment v. Coe*, 297 F. 2d 651, 658 (2 Cir. 1961).

Plaintiff argues defendants cannot complain of the damages awarded and the trial court need not explain the basis of its computation of damages. This is contrary to the law. The measure of damages is subject to appellate review, *United States National Bank v. Fabri-Valve Co.*, 235 F. 2d 565, 568 (9 Cir. 1956), and the court is required to find facts with respect to damages. *Alexander v. Nash Kelvinator Corp.*, 261 F. 2d 187 (2 Cir. 1958). Otherwise damages would cease to be a matter for review.

Punitive Damages.

To the cases we have previously called to the Court's attention which have held the Securities Exchange Act does not permit punitive damages, we add *Myzel v. Field*, 386 F. 2d 718 (8 Cir. 1967), *cert. denied* 390 U. S. 951 (1968). Plaintiff would invoke the Securities Act. The difficulty is the Securities Act applies to sales by a dealer to a customer, not to brokerage.

CONCLUSION

The judgment of the court below should be reversed
and the complaint dismissed.

Dated, February 28, 1969.

Respectfully submitted,

EMANUEL BECKER,

THOMAS A. H. HARTWELL,

COOLEY, CROWLEY, GAITHER,

GODWARD, CASTRO & HUDDLESON,

Attorneys for Defendants

Harris, Upham & Co., et ano.



Nos. 22,971, 23,017

In the

United States Court of Appeals

For the Ninth Circuit

BERTHA HECHT,

Plaintiff-Appellee-Appellant,

vs.

HARRIS, UPHAM & CO., a partnership,

HARRIS, UPHAM & CO., INC., a corporation,

Defendants-Appellants-Appellees.

Closing Brief of Bertha Hecht

FILED

JAN 31 1959

WM. B. LUCK, CLERK

DONALD F. X. FINN

63 Wall Street

New York, New York

REED H. BEMENT

MORRIS LOWENTHAL

LOWENTHAL & LOWENTHAL

405 Montgomery Street

San Francisco, California 94104

Tel. No. 986-5388

Attorneys for Bertha Hecht

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Nos. 22971 and 23017

In the

United States Court of Appeals

For the Ninth Circuit

BERTHA HECHT,

Plaintiff-Appellee-Appellant,

vs.

HARRIS, UPHAM & Co., a partnership,

HARRIS, UPHAM & Co., INC., a corporation,

Defendants-Appellants-Appellees.

Closing Brief of Bertha Hecht

PRELIMINARY STATEMENT

This Closing Brief is presented by Bertha Hecht as appellant's reply brief in No. 23017 and as appellee's principal brief in response to the opening brief of Harris, Upham & Co. in No. 22971.¹

INTRODUCTION

The opening brief of Harris, Upham & Co. fails to come to grips with the fundamental issues in this case—both as these

1. The parties will be referred to by name or as plaintiff and defendants. "C.T." references are to the Clerk's Transcript, "R.T." references are to the Reporter's Trial Transcript, and Exhibit References are to the exhibits introduced during the trial and now before this Court.

issues are presented in the Opening Brief of Bertha Hecht and, more importantly, as determined and discussed by the trial court.

Defendants' brief largely ignores the trial court's decision and presents the case as if this Court had an obligation to try it *de novo*. We respectfully submit that "'Instead of a fair and sincere effort to show that the trial court was wrong, appellant's brief is a mere challenge to respondents to prove that the court was right. And it is an attempt to place upon the court the burden of discovering without assistance from appellant any weakness in the arguments of the respondents. *An appellant is not permitted to evade or shift his responsibility in this manner.*'" *Schulz v. Wulfin*, 251 Cal. App. 2d 776, 778 (1967) (emphasis added).

Instead of merely rearguing the case, as a matter of law it is incumbent upon defendants to convincingly establish that the trial court's decision and judgment are improper.

Haynes v. Gwynn, 248 Cal. App. 2d 149, 151 (1967):

" 'The rule is well established that a reviewing court must presume that the record contains evidence to support every finding of fact, *and an appellant who contends that some particular finding is not supported is required to set forth in his brief a summary of the material evidence upon that issue. Unless this is done, the error assigned is deemed to be waived.*'" (emphasis added)

Defendants Have Failed to Meet the Burden Imposed by the "Clearly Erroneous" Rule

The defendants' brief merely *asserts* that the trial court findings are unfounded and makes little effort to demonstrate that they are "clearly erroneous." Rule 52(a), Federal Rules of Civil Procedure.

For example, defendants make two responses to the trial court's extensive findings on the inadequacy of Harris, Upham & Co.'s internal supervision and control. 283 F.Supp. at 438-439. First, they merely reargue the case by asserting that the "record con-

tains a precise description of defendants' internal supervision to assure the Securities Exchange Act is not violated" (H.U. Brief, 25). This response improperly attempts to shift the burden to plaintiff to support the trial court's findings and does not constitute an analysis from which this Court could conclude that the trial court's findings of inadequate supervision are clearly erroneous. Secondly, Harris, Upham & Co. insists that the trial court "did not find inadequate internal supervision" (H.U. Brief, 65). This assertion is directly contradicted by the clear language of the trial court (283 F.Supp. at 439):

"The Court finds and concludes from the evidence that defendant Harris, Upham did not maintain a reasonably adequate system of internal supervision and control; that it did not enforce with any reasonable diligence such system as it did maintain and that in this respect defendant Harris, Upham cannot be said to have acted in good faith within the meaning of Section 20(a) of the Securities Exchange Act (15 U.S.C. § 78t(a)) but did, on the contrary, indirectly induce, participate in, approve and accept the benefits of what we have found to be the excessive trading of the account by Wilder." (emphasis added)

Because of defendants' failure to either precisely depict and convincingly demonstrate the errors allegedly committed by the trial court or to fairly present all the evidence bearing upon the factual findings they challenge, their appeal should be dismissed out of hand.

Trial Court Findings Are Presumptively Correct

This Court has emphasized the great weight to be given to trial court findings and the broad scope of the clearly erroneous rule (*Lundgren v. Freeman*, 307 F.2d 104, 113-115 (9th Cir. 1962)), recognizing that if the rule is not firmly adhered to "everything is cast adrift." *Jacuzzi Bros. v. Berkeley Pump Co.*, 191 F.2d 632, 634 (9th Cir. 1951).

Under the clearly erroneous rule, the appellee is entitled to "the benefit of all reasonable inferences and to have the evidence viewed in a light most favorable to it, and if when so viewed there was substantial evidence to sustain the judgment it cannot be reversed." *Clostermann v. Gates Rubber Co.*, 394 F.2d 794, 796 (9th Cir. 1968). See also, *Weyl-Zuckerman & Co. v. Commissioner*, 232 F.2d 214, 216 (9th Cir. 1956); *United States v. Fotopulos*, 180 F.2d 631, 634 (9th Cir. 1950); *Stacher v. United States*, 258 F.2d 112, 116 (9th Cir. 1958).

A finding is clearly erroneous only when it is "without evidentiary support" or when, although there is evidence to support it, the reviewing court on the entire evidence is "left with the definite and firm conviction that a mistake has been committed." *West v. Conrad*, 182 F.2d 255 (9th Cir. 1950). See also, *Nuelsen v. Sorensen*, 293 F.2d 454, 460 (9th Cir. 1961). According to the eminent authority of Judge Learned Hand, the appellate court will reverse a trial court finding only "most reluctantly and only when well persuaded." *United States v. Aluminum Co. of America*, 148 F.2d 416, 433 (2d Cir. 1945).

Defendants' brief fails to recognize that particular regard is to be given to trial court findings which are dependent upon the credibility and demeanor of witnesses. The present case was tried by one of the most experienced trial judges in this District who carefully observed and patiently listened to all of the witnesses and to extended argument by counsel² and then sifted through the often times conflicting testimony before making findings. A number of these findings relate to the intentions of defendants. It is established that "findings as to the design, motive and intent with which men act depend peculiarly upon the credit given to

2. Cf. R.T. 4506, 4511 (The Court: "... this has been a rather long case, and it's been a hard case, however, it has been very thoroughly presented by both sides, I must say.")

witnesses by those who see and hear them." *United States v. Yellow Cab Co.*, 338 U.S. 338, 341 (1949). See also, *United States v. Aluminum Co. of America*, 148 F.2d 416, 433 (2d Cir. 1945):

"[The trial judge's] duty is to sift the evidence, to put it into logical sequence and to make the proper inferences from it; and in the case of a record . . . like that before us, it is physically impossible for an appellate court to function at all without ascribing some prima facie validity to his conclusions. . . . [W]hatever may be said in favor of reversing a trial judge's findings when he has not seen the witnesses, when he has, and *in so far as his findings depend upon whether they spoke the truth, the accepted rule is that they 'must be treated as unassailable.'*" (emphasis added)

Defendants repeatedly fail to accept the fact that the trial court here has performed, and ably so, its duty of weighing and sifting the evidence. For example, defendants state that the *Colonial* shares were "gifts made of securities by Mrs. Hecht to Mrs. Wilder" (H.U. Brief, 27). Although Mr. Wilder claimed Mrs. Hecht gave he and his wife these securities, Mrs. Hecht *denied* that she had (See Opening Brief of Bertha Hecht, 15-16) and the trial court found that Mr. Wilder's version was not the truth. 283 F.Supp. at 442. From defendants' description of this significant transaction, the reader is left without any inkling of the conflict in the testimony and the trial court's resolution of that conflict.

The entire responsibility for "deciding doubtful fact questions in a non-jury case" is "that of the district court." *Pendergrass v. New York Life Ins. Co.*, 181 F.2d 136, 138 (8th Cir. 1950).

Defendants, without foundation, attack plaintiff's general veracity (H.U. Brief, 10)—which at this stage they may not do:

"In so evaluating the evidence [under Rule 52(a)] *the trial court's appraisal of the credibility of the witnesses is to be*

accepted, no challenge to such appraisal being permissible in the appellate court. Appellants' attack upon the credibility of witnesses whose testimony was apparently accepted by the court will therefore be disregarded."

Nuelsen v. Sorensen, 293 F.2d 454, 460 (9th Cir. 1961)
(emphasis added)

Moreover, it must be recognized that the trial judge had the obligation to, and did, resolve whatever inconsistencies there may have been within the testimony of each witness. *Peterson v. Peterson*, 74 Cal. App. 2d 312, 318-319 (1946). Defendants frequently rely on "yes" and "no" answers to questions given by Mrs. Hecht, and give them an import obviously not intended by her, as shown by her testimony when she was given the opportunity to explain matters in detail. The trial judge made his findings after hearing all of plaintiff's testimony, the testimony of defendants and the other witnesses, and after considering the massive documentary evidence which was introduced. Defendants cannot now take only a part of Mrs. Hecht's testimony and demand that the trial court's findings be restricted to that part—to the exclusion of her total testimony and all the other testimony and evidence in the case.

Defendants' approach here is similar to that pursued in another case decided by this Court wherein the defendants sought to overturn the trial court's findings on the basis that the testimony of a witness and of the plaintiff (an 80 year old widow in a disturbed mental and physical condition) should be entirely discredited. This Court responded:

"Neither were impeached to the extent that their entire testimony should be disbelieved. The trial judge made this clear in his decision. We add that not only did the trial judge have the testimony of Mrs. Connell and Mr. Holdorf, but he also had the additional benefit of many cancelled checks and

other documentary evidence, as well as the testimony of other witnesses and defendants.”

Errion v. Connell, 236 F.2d 447, 456 (9th Cir. 1956)

The trial judge in the present case likewise had before him a great deal of evidence—both documentary and testimony—upon which to draw in arriving at his findings. It is these findings that defendants must prove are clearly erroneous. Their failure to even attempt this task renders the judgment impervious to their attack.

Although the burden of demonstrating that there was substantial evidence to support the findings of the trial court does not rest with plaintiff, this brief will do so when it seems appropriate in responding to defendants, so as to show beyond the shadow of any doubt that defendants’ appeal is unmeritorious. Because defendants frequently discuss the same issue at two or three different places within their brief, plaintiff will attempt to gather together these sections and respond to them at one time.

THE JUDGMENT WAS PROPERLY ENTERED AGAINST HARRIS, UPHAM & CO., INC.

Defendants now contend, for the first time in this litigation, that the judgment (C.T. 1060-1061) should not have been entered against Harris, Upham & Co., Inc. because “[n]o evidence of its [the corporation’s] assumption of liability [attributable to the partnership] was tendered. This is not a disputable issue.” (H.U. Brief, 4)

In view of its conduct in this case it is not surprising that Harris, Upham & Co., Inc. seeks to avoid its responsibility for the judgment entered herein even though it has repeatedly admitted, both orally and in writing, that it is liable for any judgment which might be entered against the partnership.

THE CORPORATION ADMITTEDLY ASSUMED THE LIABILITY OF THE PARTNERSHIP

One need not, however, look further than the Pre-Trial Order to find conclusive confirmation of the fact that such liability was

accepted, no challenge to such appraisal being permissible in the appellate court. Appellants' attack upon the credibility of witnesses whose testimony was apparently accepted by the court will therefore be disregarded."

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THE CORPORATION ADMITTEDLY ASSUMED THE LIABILITY OF THE PART- NERSHIP

One need not, however, look further than the Pre-Trial Order to find conclusive confirmation of the fact that such liability was

assumed. In the Pre-Trial Order (C.T. 368) there are listed a number of facts which are "*admitted by all of the parties.*" Fact numbered 2 from Plaintiff's Final Pre-Trial Statement is listed as one of these admitted facts. This admission reads:

"Harris, Upham & Co., Inc. is the successor in interest to Harris, Upham & Co., a partnership, and is responsible for any liabilities of Harris, Upham & Co. to the plaintiff." (C.T. 250) (emphasis added)

The draft of the Pre-Trial Order, prepared by plaintiff's counsel at the trial court's direction, was submitted to and approved by defendants' counsel prior to its submission to the court for signature. Harris, Upham & Co., Inc. is therefore clearly bound by this admission of fact. It should also be noted that the Pre-Trial Order states it "*is admitted and agreed by counsel of record herein that Harris, Upham & Co., Inc. is a party defendant to this action*" (C.T. 371). See also R.T. 11, 171-172.

We also note that at the outset of the case, Harris, Upham & Co., Inc.'s then counsel (John B. Bates, Esq. of Messrs. Pillsbury, Madison & Sutro) stated:

"Counsel, I might say for the record we are not making issue as to the identity of Harris, Upham & Co. as a corporation or partnership. The corporation assumed the liabilities of the partnership so there is no problem in that regard."

"I think we are appearing at this time for the corporation since the partnership had been changed into corporate form, I believe, but I am saying for the record that we don't draw any distinction insofar as the corporation, partnership or corporation is concerned for this lawsuit. The corporation assumes the liabilities of the partnership, if any there are." Deposition of Arthur R. Mejia, December 6, 1965, pp. 5-6, (emphasis added)

Further, in a verified answer to an interrogatory introduced into evidence, Harris, Upham & Co. stated that "No claim is made

that Harris, Upham & Co. as it is presently constituted is not responsible for liabilities, if any, arising out of Mrs. Hecht's transactions with Harris, Upham & Co. during the period she dealt with that partnership." (Plaintiff's Exhibit 192-1, p. 45).

It is significant that defendants never raised this issue in the District Court before or after trial. Although defendants moved to dismiss the case after the trial court entered its initial decision on January 19, 1968, this motion did not include as a ground for dismissal that the corporation could not be held liable for the misconduct found to have occurred (C.T. 953). Further, defendants did not move under Rule 59(e) or Rule 60 of the Federal Rules of Civil Procedure to alter or amend the judgment in this respect *nor was this ground included in defendants' Statement of issues to be presented on appeal* (C.T. 1075-1076).

DEFENDANTS' STATEMENT OF THE CASE

(H.U. Brief, 4-9)

The Pleadings (H.U. Brief, 5-6)

Defendant's analysis of plaintiff's pleadings and claims distorts them beyond recognition. This Court is invited to compare the actual complaint (C.T. 1-11) with defendants' characterization of it. Since what is important is the nature and substance of those claims, we summarize them for the convenience of the Court.

Plaintiff's claim of fraud was clearly based on the anti-fraud provisions of the Federal Securities laws (C.T. 1, 3, 6, 9, 12, 18, 5-88, 258, 262-265, 531-532; R.T. 34-36, 63, 3880-3885, 3930-3937) and the Commodity Exchange Act (C.T. 89, 539-543, 3938-3940) as well as the common law of California (C.T. 9-10, 547) and the Rules of Fair Practice of the NASD (C.T. 11-12). The principal specific fraudulent act alleged was that defendants effected securities and commodities transactions which

assumed. In the Pre-Trial Order (C.T. 368) there are listed a number of facts which are "*admitted by all of the parties.*" Fact numbered 2 from Plaintiff's Final Pre-Trial Statement is listed as one of these admitted facts. This admission reads:

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The Pleadings (H.U. Brief, 5-6)

Defendant's analysis of plaintiff's pleadings and claims distorts them beyond recognition. This Court is invited to compare the actual complaint (C.T. 1-11) with defendants' characterization of it. Since what is important is the nature and substance of those claims, we summarize them for the convenience of the Court.

Plaintiff's claim of fraud was clearly based on the anti-fraud provisions of the Federal Securities laws (C.T. 1, 3, 6, 9, 12, 18, 86-88, 258, 262-265, 531-532; R.T. 34-36, 63, 3880-3885, 3930-3937) and the Commodity Exchange Act (C.T. 89, 539-543, 3938-3940) as well as the common law of California (C.T. 9-10, 547) and the Rules of Fair Practice of the NASD (C.T. 89). The principal specific fraudulent act alleged was that defendants effected securities and commodities transactions which

were excessive in view of plaintiff's investment needs and objectives (C.T. 5-6, 207-208, 241-245). The law and facts regarding this "churning" are discussed *infra*, pp. 38-51.

Plaintiff claimed from the outset that the specific fraudulent acts alleged also constituted a breach of the fiduciary duties owed to her by defendants under both Federal law (C.T. 6-7, 92-93, 206, 211, 262-264, 558) and the common law of California (C.T. 10, 94-95, 268, 558-561).

Plaintiff sought compensation for specified items of damages proximately caused by defendants' fraudulent conduct (C.T. 7, 11, 73-74, 246-247).

Far from absolving Harris, Upham & Co. (H.U. Brief, 6), plaintiff alleged it employed and controlled Mr. Wilder (C.T. 2, 206, 209, 240, 244, 865), participated in and induced the fraud perpetrated upon her (C.T. 86-89, 208-209, 244-245, 263-265, 349-350, 356-357, 448-451, 524-527, 568-569), ratified Mr. Wilder's conduct (C.T. 566, 822-828, 866), and was liable as a principal under 7 U.S.C.A. § 4b (C.T. 569).

Harris, Upham & Co.'s counsel *admitted that the firm was liable for its employees' improprieties if it did not adequately supervise them* (R.T. 3846), and the trial court *found* that the firm did not have adequate supervision. 283 F.Supp. at 439.

Although plaintiff did not claim that her account was made formally discretionary by written authorization, she did claim that it was in fact discretionary because of the control exercised over it by Mr. Wilder, and that Mr. Wilder and his employer abused this discretion and trust reposed in them (C.T. 3, 5, 68-71, 204, 207, 238, 240; Cf. Plaintiff's Supplemental Pre-Trial Statement, dated February 2, 1967, p. 11).

Mr. Wilder *testified* he had unlimited discretion over plaintiff's account (R.T. 1180-1183) and *admitted* that in handling plaintiff's account he violated the rules prohibiting discretionary orders (R.T. 2235-2236; C.T. 570). It is clear the account was

operated on a discretionary basis in violation of the applicable rules and regulations (C.T. 611, 638-647).

Pretrial Proceedings (H.U. Brief, 7)

Defendants' motion to dismiss for lack of subject matter jurisdiction, denied by the trial court, is discussed *infra*, pp. 22-24. For discussion of the trial court's jurisdiction over the commodity transactions, see *infra*, pp. 27-36.

The Court's Memoranda of Decision (H.U. Brief, 7-9)

1. Contrary to the implication of their brief, defendants were given every opportunity to and did present whatever evidence they possessed on the Itek and Colonial transactions. See *infra*, pp. 79-82.

2. As to the "further damages" awarded plaintiff (H.U. Brief, 9), the following facts should be noted:

(a) *The commodities losses of \$78,000 awarded* were realized losses on top of the \$98,000 in commissions paid by plaintiff on commodities transactions. 283 F.Supp. at 436, 440. Although the average amount in the commodities account at any one time was only approximately \$35,000, the commodities losses were largely paid for by the sale of securities and the transfer of over \$245,000 from plaintiff's securities account to the commodities account. 283 F.Supp. at 437; Plaintiff's Exhibit 263.

(b) *The \$65,000 awarded for loss of dividend income* was awarded both because defendants purchased commodities, which do not pay dividends, and also because dividend-paying securities were sold and speculative, non-dividend paying securities purchased with the proceeds. 283 F.Supp. at 440.

(c) *The compensatory pre-judgment interest award* applied only to the \$232,000 paid by plaintiff in commissions and interest. 283 F.Supp. at 444. See *infra*, p. 95-96.

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DEFENDANTS' STATEMENT OF THE FACTS
(H.U. Brief, 9-31, 84-97)

Defendants' presentation of the facts is highly argumentative and fails to take into account their burden of demonstrating that the trial court's findings are clearly erroneous. Merely asserting that the findings are unsupported by the evidence is insufficient. Moreover, defendants select only limited parts of the record to present without fairly summarizing all the evidence bearing on the challenged findings. To respond to all of defendants' alleged facts would extend this brief beyond permissible limits and would serve little purpose. Either here or in other parts of this brief, plaintiff will respond to some of defendants' factual contentions. For a logical and coherent recitation of the basic facts of this case the Court is referred to the trial court's decision and to the Opening Brief of Bertha Hecht, 1-32.

The Plaintiff (H.U. Brief, 9-11, 84-86)

This section is apparently intended to attack the trial court's finding that plaintiff's "comprehension of the securities market was definitely limited, her comprehension of the commodities market was virtually nil and her comprehension of both was most superficial." 283 F.Supp. at 433.

Defendants first question Mrs. Hecht's credibility. This they cannot do on appeal. Moreover, *defendants have not attempted to summarize the evidence relating to plaintiff's mental condition and abilities.*

Dr. Gloria Bentinck—a qualified psychiatrist (R.T. 749-750)—testified that in 1955 plaintiff was extremely confused (R.T. 751-752), disoriented (R.T. 771, 785-786, 792), lacked good judgment about herself (R.T. 800, 808), and was disorganized and forgetful (R.T. 806-807).

A neurologist (Leon J. Whitsell, M.D.), who examined plaintiff shortly after her husband's death in January 1955, reported

that she had suffered from an "acute brain syndrome following a 'silent' cerebral infarction" (Plaintiff's Exhibit 187-1).³

In the fall of 1955, plaintiff was confined to a sanitarium and received shock treatments for her general confusion, depression and agitation (R.T. 794, 798). Both in 1955 and in recent years, electro-encephalograms have disclosed abnormal brain waves, probably resulting from organic brain damage (Plaintiff's Exhibit 187-3; R.T. 308-309, 800).

Dr. William McCreery (R.T. 300-304), who has been plaintiff's personal doctor since 1959, testified that "she has always been quite forgetful" and has a short attention span (R.T. 308), is disorganized (R.T. 317), has "a general relationship with others as a child rather than an adult" (R.T. 315), has a tendency to lean on people (R.T. 365), and "finds it difficult to pursue a course" (R.T. 364). Dr. McCreery knew "very little" about "her ability to run her financial affairs" except that she evidenced concern about her dividend income upon which she depended to live and to make charitable contributions (R.T. 363-364, 377).

Mr. William Wentworth, a distinguished and eminent San Francisco investment advisor, testified that plaintiff is "totally incapable of managing her affairs from a financial standpoint" (R.T. 1898). Plaintiff's doctor and accountants described her as "disorganized", "forgetful" and as a person who becomes "easily confused" (R.T. 317, 324:2-9, 810:23-811:2, 3411-3413, 1806:22-25). For further details regarding plaintiff, see Opening Brief of Bertha Hecht, 6-9.

In addition to the above evidence, there is far more in the record to substantiate the previously quoted trial court findings and its additional findings that plaintiff is an "unstable, erratic and commercially unsophisticated woman" who was "a naive

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customer dependent upon Wilder and on Harris, Upham." 283 F.Supp. at 433, 434. There is no further need to respond to defendants' exaggerations and misleading treatment of the record, and to the limited extent that the record may support defendants' assertions, it was considered by the trial court in reaching its findings which have not been shown to be clearly erroneous.

Plaintiff's Knowledge and Her Alleged Participation in Trading Her Account Before 1955 (H.U. Brief, 11-14)

Although defendants fail to indicate what significance they attach to this section, they apparently feel it bears on the trial court's findings as to plaintiff's lack of comprehension and as to the finding (discussed in the following section) that Mr. Wilder controlled her account.

Many of defendants' citations are simply not correct. For example, Mrs. Hecht's testimony (R.T. 2518) does not support defendants' assertion (H.U.Brief, 13) that she bet on dog or horse races. In fact, the conclusion to be drawn is directly to the contrary. Nor does the testimony cited (R.T. 2543, 2689) by defendants substantiate their claim either that plaintiff's husband "opposed her speculating in commodities" or that she "searched" the newspapers for buys (H.U. Brief, 12-13).

To deal with all of defendants' alleged facts in this manner would not only be wearisome but also of little benefit to this Court. Two general comments are appropriate:

1. The trial court has made its findings and to reargue the evidence as defendants do negates the function of the clearly erroneous rule.

2. All of these alleged facts occurred prior to 1955 and prior to the time Mrs. Hecht's condition and situation drastically changed because of the death of her husband. The NASD has recognized that what transpired before 1955 is of little import (Opening Brief of Bertha Hecht, Appendix A, pp. 12-13).

The Relationship Between Plaintiff and Wilder (H.U. Brief, 14-17, 86-91)

CONTROL OVER THE ACCOUNT

This section is primarily directed at the trial court's findings that Mr. Wilder "controlled" plaintiff's account. 283 F.Supp. at 435.

Defendants' assertions in regard to the question of control are truly remarkable and warrant examination in some detail. They state (H.U.Brief, 16-17):

"There is nothing in the record for the conclusion that Wilder recommended the amount of any security purchase or the sale of any security. There is nothing in the record to support a conclusion that all or most of his recommendations were in fact followed. The sole evidence is to the contrary. (R. 3576)."

"[The trial court] assumed, contrary to the fact, that there was some evidence Wilder determined her purchase of securities and commodities. It did not find Wilder encouraged her security trading. It found, without evidence, he encouraged her commodity trading . . ."

Merely asserting there is no supporting evidence does not effectively challenge the trial court's findings and, in any event, the record amply supports them.

In response to the question whether there was any security transaction that he "didn't recommend or didn't solicit the order from Mrs. Hecht", Mr. Wilder replied that there was *one* such security (Ampex) but that he was unable to "recall any others at the moment" (R.T. 1541-1542). The following questions and answers were then given:

"Q. And would you generally recollect that you recommended and solicited the order for all other stocks in her account?

"A. With the exception [Ampex] I mentioned. I don't recall at the moment. There may have been.

"Q. When you have the opportunity, will you look through those pages and let us know if there is any other ones that you think she—rather than you initiated?

"A. Yes, I will."

(R.T. 1542)

The "pages" referred to were those kept by Mr. Wilder which listed *every* specific security transaction in plaintiff's account in detail.

After thinking about it over night, Mr. Wilder was able to recall only *one additional security suggested by Mrs. Hecht* (R.T. 1658). With these two exceptions then, *Mr. Wilder admittedly initiated, solicited and recommended every one of the 1200-1400 securities transactions in plaintiff's account!* Moreover, he admittedly exercised complete discretion in effecting transactions when Mrs. Hecht was in the hospital or on a trip (R.T. 1179-1184, 1142-1143, 1129).

As to the *commodities* transactions, the testimony of Mr. Wilder is equally clear—he initiated and recommended every single transaction.

"Q. You recommended the purchase of all these [commodities], didn't you?

"A. I believe so.

"Q. And she followed your recommendations?

"A. Yes.

"Q. And your suggested recommendation and advice was with respect to the purchase of all these commodities that I have listed?

...
"THE WITNESS: Yes.

"Mr. Finn: Q. Did she ever refuse to follow your recommendation or advice?

"A. Very seldom.

"Q. When was any such occasion that you can recall?

"A. I don't recall just at present. I just have the memory

that occasionally and very seldom my suggestion was not followed."

(R.T. 1436-1438)

That defendants, in the face of this testimony, can now assert (H.U. Brief, 16, 87) that there is nothing in the record supporting the conclusion that Wilder recommended almost all of the security and commodity transactions is startling.

Equally surprising is defendants' claim that not only does the record not support the conclusion that "all or most" of Mr. Wilder's recommendations were in fact followed but that the "sole evidence is to the contrary (R. 3576)" (H.U. Brief, 16).

This "sole" evidence consists of the following testimony:

"Q. Mr. Wilder, is there any transaction in Mrs. Hecht's account at Harris Upham that you can definitely tell us without reservation was not discretionary?

"A. Every time I called her and got orders from her, why, they were not discretionary. And I called her every day when she was available.

"Q. Well, you initiated the orders, didn't you, when you asked her if she would go along with them?

...

"A. We talked about the markets, she would talk about the market and I would get an order and put it in.

"Q. Would you suggest the idea to her?

"A. Sometimes I suggested the order, sometimes she suggested what she wanted.

"Q. What happened most of the time?

"A. *Most of the time I made the suggestion.*

"Q. *And most of the time she followed it?*

"A. Yes.

"Q. Always she followed it?

"A. Not always.

"Q. How often didn't she?

"A. I don't know."

(R.T. 3576) (emphasis added)

Thus, not only does Mr. Wilder say that *most* of the time his suggestions were followed, but he was unable to recall any specific instance when his suggestion as to a transaction was not followed.

Nor was this testimony the "sole" evidence. Mr. Wilder earlier testified that it was "very seldom" that his recommendations on commodities were not followed (R.T. 1438) while Mrs. Hecht testified she did not know what was being done with her accounts, unsuccessfully seeking an explanation from Mr. Wilder (R.T. 2702-2704, 2783).

Finally, defendants assertion that the trial court did not find that "Wilder encouraged her security trading" (H.U. Brief, 17), cannot be squared with the trial court's finding that "there can be no doubt" that "the volume and frequency of the security trading was left to Wilder" and that plaintiff "did not insist upon trading in any particular volume or with any particular frequency." 283 F.Supp. at 435.

PROPOSED CUSTODY ACCOUNT

Defendants contend that plaintiff "admits she rejected Wilder's recommendation in 1956 to put half her capital into a trust account" (H.U. Brief, 14). The record actually discloses that Mr. Wilder suggested a custody account (Plaintiff's Exhibit 101-D) which is no more than a coupon clipping account where a bank holds securities for safekeeping. No purchase or sale is effected except upon express "receipt of instructions" from the account holder or anyone given power over the account. Such an account is not in any shape, manner or form a "trust account." Plaintiff's Exhibit 101-D.

The services provided by the bank for such an account—at a fee—are provided without charge by a stockbroker, except insofar as commissions are charged on transactions effected. There was, therefore, no benefit to be derived by plaintiff from using such an account.

Mrs. Hecht wanted her securities to be handled in the same manner they had been handled by her husband (R.T. 2388-2389,

2459, 2620-2621, 2682)—to be held largely intact without being sold so that she could live off the dividend income (R.T. 2954-2957, 1245-1250).

Further, it is clear that Mrs. Hecht did not understand how either the proposed custody account or a trust account would operate. She thought that the trust could decline in value and that if her securities were placed in a trust the income from them would not be available to her to live on (R.T. 2955, 3035-3036).

MRS. HECHT'S TRUST AND CONFIDENCE IN MR. WILDER

As to Mrs. Hecht's trust and confidence in Mr. Wilder (H.U. Brief, 16-17), *Mr. Wilder testified that she had trust and confidence in him and relied on his judgment* (R.T. 1224, 1506). Mr. Wilder's attorney, who had previously represented Mrs. Hecht, testified that Mrs. Hecht thought that Mr. Wilder "was a very fine man and an excellent broker and very honest, and that he was doing a good job for her" (R.T. 999). Mrs. Hecht named Mr. Wilder in her wills as a legatee and described him as her "friend and financial advisor" (R.T. 2413-2415, 988; Mahoney Exhibits 1-3). That Mr. Wilder completely controlled her account is also indicative of Mrs. Hecht's trust and confidence in him.

Mrs. Hecht testified that she trusted and had confidence in Mr. Wilder until March 1964 (R.T. 2924, 2926, 3024), although she did fear him. This fear did not prevent Mr. Wilder from continuing his control over her and her account and it is apparent that what Mrs. Hecht meant by her testimony was that subconsciously she felt something was not quite right but she attempted to suppress these feelings. After several exhausting days of testimony, Mrs. Hecht responded as follows to questions from the court:

"THE COURT: Now, can you tell us when you first came to fear [Mr. Wilder]?"

"THE WITNESS: The first I felt a slight fear in '55. But then afterwards it came the thought: Well, my husband trusted him I must trust him, and it gave me the idea that I

must be mistaken. But still, somehow, I had that fear against him, but felt my husband trusted him so I must. So it wasn't until later that I realized that I was right.

"THE COURT: When did you realize you were right in fearing him?

"THE WITNESS: Well, that became final in 1964."
(C.T. 3020)

It should also be remembered that Mr. Wilder picked up all of plaintiff's account papers weekly or more often so that she did not have them to show to anyone who might help her (283 F.Supp. at 434) and that her schizophrenic, passive and dependent personality (Opening Brief of Bertha Hecht, 8) prevented her from raising outward objections even though she at times felt uneasy with Mr. Wilder.

It is clear that the activity in plaintiff's account resulted from Mr. Wilder's domination of Mrs. Hecht. He was assured that whatever he did would not meet with her objection, and he acted accordingly to further his own interests rather than hers. Her securities affairs were, as the trial court found, entirely left in Mr. Wilder's hands and under his control. 283 F.Supp. at 435.

The Court's Findings With Respect to Plaintiff's Knowledge and "Laches, Waiver and Estoppel" (H.U. Brief, 17-21)

Defendants contentions regarding estoppel, waiver and laches are discussed *infra*, pp. 60-74.

Plaintiff's Security Trading (H.U. Brief, 21-23)

Plaintiff's Commodity Trading (H.U. Brief, 23-25)

Mrs. Hecht's Profits and Losses (H.U. Brief, 28-29)

The Losses in Commodity Trading (H.U. Brief, 29)

These sections relate to the issue of churning and, accordingly, are discussed under that heading. See *infra*, pp. 38-51.

Defendants' Supervision (H.U. Brief, 25-26)

The topic of supervision is a part of the subject of the liability of Harris, Upham & Co. and is discussed *infra*, pp. 54-57.

Findings by the Court on Evidence Allegedly Not Admitted Against Defendant Harris, Upham & Co. and "Itek" and "Colonial" (H.U. Brief, 26-28)

The trial court did not exclude the evidence relating to events prior to May 1, 1957 as to Harris, Upham & Co. Rather, it ruled that "the testimony is introduced for the present insofar as it may affect the defendant Wilder, but not for the purpose of binding the defendant Harris, Upham or Mejia unless the Court thereafter rules that the testimony becomes applicable" (C.T. 2314). The trial court explicitly warned that it might later rule the testimony was binding against Harris, Upham & Co. (C.T. 2314-2315).

Defendants' counsel were, therefore, required to cross-examine and to put in evidence relating to this period if they so chose. They cannot now attempt to claim surprise or prejudice because this evidence is referred to in the trial court's decision.

Moreover, as to the commodities account, the trial court's findings relating to the churning of commodities are largely based upon the facts and figures of the activity in that account after May 1, 1957. It is clear from these figures alone that defendants were more concerned with their own commissions than with Mrs. Hecht's needs and interests. No reference to the period before May 1, 1957 is necessary to substantiate the court's findings in this regard.

The Itek and Colonial transactions are discussed *infra*, pp. 75-89.

Commingleing of Assets (H.U. Brief, 29-30)

This section is discussed under the heading of the court's jurisdiction over commodities transactions. See *infra*, pp. 27-32.

Damages (H.U. Brief, 30-31)

Plaintiff's response to defendants' comments relating to the trial courts award is set forth *infra*, pp. 89-99.

ARGUMENT AND RESPONSE TO DEFENDANTS' ARGUMENTS**I****THE TRIAL COURT PROPERLY HELD IT HAD JURISDICTION
OVER PLAINTIFF'S CLAIMS**

(H.U. Brief, 35-41)

Defendants' contend that there was not and is not Federal subject matter jurisdiction over plaintiff's claims. Although entitled to raise this issue on appeal, defendants confuse the issue by adding unrelated and disjointed contentions regarding the form of the pleadings and an alleged "deprivation" of their right to raise lack of jurisdiction prior to the trial. These irrelevant issues are not made explicit and are raised only by innuendo. This results in considerable ambiguity and necessitates setting forth basic principles relating to pleading and jurisdiction and also requires plaintiff to attempt to impose order upon defendants' chaos.

A.**DEFENDANTS WERE GIVEN EVERY OPPORTUNITY TO RAISE, AND DID RAISE,
LACK OF JURISDICTION AS AN ISSUE**

Subpoint A (H.U. Brief, 35-36) apparently contends, when placed in conjunction with earlier assertions (H.U. Brief, 7), that Harris, Upham & Co. was deprived of its right to raise the lack of subject matter jurisdiction it now alleges. The record is clearly to the contrary.

Defendants' answer to the complaint did not contain lack of jurisdiction over the subject matter as an affirmative defense (C.T. 18-24). Nor did they seek to amend the answer to include this defense or make a formal motion to dismiss on these grounds (C.T. 231).

On January 28, 1967, however, defendants filed a pre-trial statement (thereafter supplemented) which for the first time asserted that the case should be dismissed for lack of jurisdiction and for a failure to state a claim upon which relief could be based. The Court did not refuse to consider these matters, as Harris,

Upham & Co. states (H.U. Brief, 7). Rather, Judge Sweigert on February 24, 1967 informed the parties that he would decline then to rule on whether or not there was federal jurisdiction of the subject matter but would consider the matter further. On March 16, 1967 Judge Sweigert declined to grant a motion to dismiss as made in substance and effect by defendants' pre-trial statements and advised defendants that the motion should properly be brought in the Law and Motion Department.⁴

Defendants initially followed this advice and on March 29, 1967 served on plaintiff's counsel a motion to shorten the time of notice for a hearing on a motion to dismiss and for summary judgment and in which they set forth the course of events referred to above. Harris, Upham & Co., however, then decided for its own reasons to withdraw this motion and did not thereafter file any formal motion to dismiss in the Law and Motion Department. (See Exhibit E between C.T. pages 476 and 477).

Further, Judge Sweigert recognized defendants' right to raise the defense of lack of jurisdiction by expressly including it in the Pre-Trial Order of April 4, 1967 as an issue (C.T. 363, 367, 370). On April 25, 1967—the day preceding the actual commencement of the trial—Judge Sweigert heard extensive argument from counsel on defendants' motion to dismiss for lack of jurisdiction and took the matter under submission (R.T., April 25, 1967).

At the close of plaintiff's case in chief arguments on this motion were again heard (R.T. 3640 et. seq.). The trial court reserved decision on this motion until the close of all the evidence, pursuant to Rule 41(b) of the Federal Rules of Civil Procedure (R.T. 4196-4197), and thereafter denied the motion (R.T. 4752, 4754),⁵ holding that there was federal jurisdiction over the sub-

4. The commencement of the trial had been set for April 24, 1967 since February 1967.

5. The denial of the motion to dismiss by the trial court is not an appealable order. *American Concrete Agr. Pipe Ass'n. v. No-Joint Con. Pipe Co.*, 331 F.2d 706, 709 (9th Cir. 1964); *MCL Film, S.A. v. Twentieth Century-Fox Film Corp.*, 8 F.R. Serv. 2d 12b.26, Case 2 (9th Cir. 1964).

ject matter of the action under the Federal Securities Laws. 283 F.Supp. at 422.

It is apparent, therefore, that Harris, Upham & Co. was given every opportunity to raise the question of lack of jurisdiction and that the trial court carefully considered its jurisdiction. The question of lack of jurisdiction was raised prior to the trial even though defendants filed no formal motion and was also considered during the trial. Under Rule 12(d) of the Federal Rules of Civil Procedure, even had defendants filed a motion the hearing and determination of it could have been deferred until the trial. Defendants certainly are in no position to complain that the issue of jurisdiction was not decided before trial since they chose to file no formal motion to dismiss and failed to raise the issue of jurisdiction by answer.

B.

JURISDICTION WAS ADEQUATELY ALLEGED BY PLAINTIFF

Defendants' contentions as to the allegations of jurisdiction (H.U. Brief, 35-39) ignore the role of pleadings in the federal courts and the role of a motion to dismiss. A motion to dismiss is not designed to challenge ambiguity, indefiniteness or lack of particularity in pleadings, although defendants believe to the contrary (H.U. Brief, 35). *Harman v. Valley Nat. Bank of Arizona*, 339 F.2d 564, 567 (9th Cir. 1964); *Bowles v. Wheeler*, 152 F.2d 34, 41 (9th Cir. 1945), cert. denied, 326 U.S. 775 (1945).

Plaintiff's complaint contains much more than a "short and plain" statement of the grounds upon which the courts' jurisdiction depends, and sets forth considerable detail of fact showing that plaintiff was entitled to relief (C.T. 1-11).

A complaint is sufficient if it gives the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests. 1 A Barron and Holtzoff, *Federal Practice and Procedure*, § 255, pp. 52-54. This approach is made possible by "the liberal

opportunity for discovery and the other pretrial procedures established by the Rules to disclose more precisely the basis of both claim and defense and to define more narrowly the disputed facts and issues." *Conley v. Gibson*, 355 U.S. 41, 47-48 (1957).

Defendants ignore these elementary principles and allege a failure to state a claim for relief, ambiguity and other shortcomings in plaintiff's pleadings (H.U. Brief, 35-39). These contentions are irrelevant to the issue of lack of jurisdiction over the subject matter and should not be considered by this Court.

C.

THERE IS FEDERAL JURISDICTION OVER A CLAIM THAT A SECURITIES ACCOUNT HAS BEEN CHURNED

In spite of its verbiage and irrelevancies, defendants' position on jurisdiction eventually reduces itself to the bald assertion that churning is not a violation of the Federal Securities laws (H.U. Brief, 39-41).

Defendants cannot plead a lack of notice of plaintiff's claim of churning for it was repeatedly alleged in her complaint and Pre-Trial Statements (e.g., C.T. 5, 86, 207, 241). In fact, defendants acknowledged the primacy of the churning claim:

"Defendants do not contest the right to jury trial to the extent that damages should be alleged and proved proximately *resulting from a fraudulent 'churning'*, in which case her damages would be limited to the excessive amounts of commission paid." (C.T. 341) (emphasis added)

Contrary to defendants' assertion that churning was only incidentally alleged as a breach of trust (H.U. Brief, 5, 39), churning was alleged *both* separately and as one indication of defendants' breach of their fiduciary duties. Even if it had been alleged as defendants assert, this would not have deprived the District Court of jurisdiction, for if churning is a violation of the Federal Securi-

ties laws then regardless of how pleaded there was jurisdiction to hear the case on the merits.⁶

Moreover, this court has stated that jurisdiction is in the first instance a "question of fact to be determined by the trial judge." *Stacher v. United States*, 258 F.2d 112, 116 (9th Cir. 1958). In the present case this principle is applicable to the trial court's finding that the suit was brought for violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 (283 F.Supp. at 442), rather than only for a breach of trust or breach of contract as defendants claim (H.U. Brief, 5, 37). Defendants have failed to show that the trial court's jurisdictional finding is clearly erroneous.

We respectfully refer the Court to plaintiff's discussion of churning and the many authorities there cited (*infra*, p. 42) supporting the trial court's holding that churning violates Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder.

We do note however, that this Court has itself twice affirmed the SEC's revocation of a broker's registration for violating Section 10(b) and Rule 10b-5 by *churning* customers' accounts.

Russell L. Irish, SEC Securities Exchange Act Release No. 7687, CCH Fed. Sec. L. Rep., para. 77,274 (1964-1966 Transfer Binder), aff'd 367 F.2d 637 (9th Cir. 1966), cert. denied, 386 U.S. 911 (1967)

J. Logan & Co., 41 SEC 88 (1962), aff'd sub nom. *Hersh v. SEC*, 325 F.2d 147 (9th Cir. 1963), cert. denied, 377 U.S. 937 (1964)

Certainly defendants are required to demonstrate in what way the numerous decisions of the SEC and of the courts—including the trial court here—are wrong in holding that churning violates

6. As the party who brought suit, plaintiff is "master to decide" what law—federal or state—she "will rely upon." *Matheson v. Armbrust*, 284 F.2d 670, 673-674 (9th Cir. 1960).

the Federal Securities laws. Instead of attempting this formidable task, defendants concentrate on alleged deficiencies of plaintiff's pleading of churning (H.U. Brief, 41) and on churning actions founded upon Section 15 of the Securities Exchange Act (H.U. Brief, 40) rather than upon actions which, as in the present case, are based upon Section 10(b) of the Securities Exchange Act, Rule 10b-5 promulgated thereunder and upon Section 17(a) of the Securities Act of 1933.⁷

Because defendants neither seriously deal with churning as a violation of the Federal Securities laws nor even discuss the many cases dealing with it, the trial court's determination that there was jurisdiction in the federal courts to hear plaintiff's claims should be affirmed. Clearly, churning is a violation of the Federal Securities laws and the trial court rightly heard and ruled on the merits of plaintiff's churning claim.

II

THE TRIAL COURT PROPERLY HELD IT HAD JURISDICTION TO CONSIDER THE COMMODITY TRANSACTIONS EFFECTED FOR PLAINTIFF'S ACCOUNT

(H.U. Brief, 41-45)

The trial court's holding that it had jurisdiction to deal with the commodity transactions in plaintiff's account and to award damages resulting from the churning of commodities (283 F. Supp. at 437) was proper and should be affirmed.

A.

THE COMMODITIES AND SECURITIES WERE COMMINGLED AND WERE PART OF A SINGLE FRAUDULENT SCHEME

The commodity transactions effected by defendants for plaintiff's account were properly before the trial court for they are

7. One of the two cases cited by defendants relating to Section 15 expressly holds that actions which are barred by the federal statute of limitations applicable to that Section can nevertheless be brought under Section 10(b) and Rule 10b-5 and are subject to the applicable State statute of limitations for fraud. *Maher v. J.R. Williston & Beane, Inc.*, 280 F. Supp. 133, 142 (S.D.N.Y. 1967).

embraced within the prohibition of Rule 10b-5 forbidding the direct or *indirect* use of any scheme to defraud or engaging in *any*⁸ act or course of business which operates as a fraud and deceit "*in connection with*"⁹ *the purchase or sale of any security*. It is primarily on this basis that the trial court held it had jurisdiction over the commodities transactions in this case. 283 F. Supp. at 437.

That the trial court's holding is correct is convincingly demonstrated by a comparison of the present case with *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956), the leading precedent in this field.

In *Errion*, the defendants misrepresented the value of oyster lands to induce Mrs. Connell to exchange her securities and other consideration for the worthless lands. The defendants appealed from the trial court's decision in favor of the plaintiff, contending that because non-securities were involved as well as securities there was no federal jurisdiction under Section 10(b) of the Securities Exchange Act and Rule 10b-5. This Court disagreed (236 F.2d at 454):

"We are of the opinion that the Act of 1934 was designed to cut out 'sharp practices' and fraudulent schemes involving securities, and the fact that there may be a co-mingling of securities with non-securities in the scheme does not oust the United States District Court of jurisdiction."

Moreover, this Court effectively responded to Harris, Upham & Co.'s present contention (H.U. Brief, 42-44) that there is no jurisdiction—federal or pendent—over the commodities transactions in plaintiff's account (236 F.2d at 454):

"It is alleged in the complaint in our case, and the trial court found, a *single cause of action* involving a *single fraudulent scheme* to defraud Mrs. Connell of her property. There were

8. Cf. *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 396-397 (2d Cir. 1967).

9. Cf. *Commerce Reporting Co., Inc. v. Puretec, Inc.*, CCH Fed. Sec. L.Rep., para. 92,252 (S.D.N.Y. 1968).

involved two types of property, one being securities over which the federal court had jurisdiction, and the other non-securities over which the federal court normally has no jurisdiction. But the single fraudulent scheme arising out of the same set of facts encompassed both types of property. The thought of requiring two law suits in this situation is untenable. We therefore hold that the trial court could correctly award damages for the entire fraudulent scheme, even though non-securities were involved."¹⁰

The parallels between this language and the present case are obvious and telling. Plaintiff alleged that defendants engaged in a single fraudulent scheme and practice to defraud her of her property. The primary means of effecting this scheme was to engage in both securities and commodities transactions so as to generate commissions for defendants without concern for plaintiff's best interests. (C.T. 2-3, 6, 207-210, 241-245).

The trial court found that the "*excessive trading of plaintiff's account by Wilder in both securities and commodities did constitute a single scheme.*" 283 F.Supp. at 437 (emphasis added). The trial court also found that Mr. Wilder induced Mrs. Hecht to open a commodities account to provide an additional opportunity for generating commissions and that the only conceivable reason Wilder encouraged plaintiff to enter into and remain in the commodities market for nearly seven years was to benefit himself by generating commissions.¹¹ 283 F.Supp. at 437.

10. Similarly, in *Goodman v. H. Hentz & Co.*, 265 F.Supp. 440, 443-445 (N.D. Ill. 1967) federal jurisdiction was upheld where there was a "single fraudulent scheme" by a stockbroker involving misrepresentations concerning both the plaintiffs' securities and commodities transactions.

11. The lower margin requirements in effect for commodities, as compared to securities, means the volume of transactions and thus the commissions which can be generated *from the same amount of capital* is correspondingly higher. In the present case, while \$91,000 (including \$15,000 mark-ups on riskless over-the-counter principal transactions) was generated from the securities account, commissions of \$98,000 were taken from plaintiff's commodities account on transactions of a total market value of over \$89 million (Plaintiff's Exhibits 283, 292).

Both Mrs. Hecht and Mrs. Connell were defrauded out of their property by a single scheme encompassing both securities and non-securities.¹² Both were defrauded of their securities because of fraudulent conduct relating to non-securities. The "thought of requiring two law suits" is as untenable in Mrs. Hecht's situation as it was in that of Mrs. Connell.

Defendants cite *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 253 F.Supp. 359 (S.D.N.Y. 1966) for the proposition that a commodity future is not a security. This case, however, supports plaintiff's position for while holding that a sugar futures contract was not an "investment contract", it denied a motion to dismiss the claim under Section 10(b) because there was a "further claim that the unauthorized purchases [of commodity futures] were followed by a conversion of \$58,041.25 from Sinva's New York *security* account." 253 F.Supp. at 367. This connection with securities was sufficient to bring the commodities transactions within the scope of Section 10(b) and Rule 10b-5.

Defendants fail to consider the trial court's finding of a single fraudulent scheme while merely denying—without analyzing the record (H.U. Brief, 29-30, 43)—that *the trial court was correct in finding that the securities and commodities transactions and plaintiff's assets in these two accounts were inextricably commingled*. 283 F.Supp. at 437.

The *record* itself is clear on this point. Most importantly, as the trial court notes (283 F.Supp. at 437), the commodities transactions and losses of \$176,000 were largely financed by the sale of securities and the transfer of the resulting funds to the commodities account (Plaintiff's Exhibit 263 (C.T. 423)).

While \$245,000 was transferred in this manner to the commodities account, only \$32,500 was directly deposited by plaintiff into that account (C.T. 792), the opening of which was induced by

12. Assuming for the present argument that commodities are not securities.

Mr. Wilder to utilize the excess of Mrs. Hecht's dividend income (R.T. 2400). These transfers were authorized by the margin and loan agreements which Harris, Upham & Co. required plaintiff to execute and such transfers were made without plaintiff's knowledge or approval (R.T. 2957) and some were made when plaintiff was in the hospital or on a trip. (C.T. 638-646). The margin and loan agreement also pledged both commodities and securities as security for any amounts owing Harris, Upham & Co. Plaintiff's Exhibits 95, 96, 97.

Defendant Arthur R. Mejia testified that securities and commodity futures are handled in basically the same way insofar as the customer is concerned. The same registered representative handles either type of transaction with similar confirmations and monthly statements being sent to the customer (R.T. 664-667).

Further, Mr. Wilder commingled the two accounts in his false summaries which purported to represent Mrs. Hecht's overall investment picture. One of the major misrepresentations made in the last such summary—that of March 29, 1963—was the omission from the summary of the unrealized losses on commodities then in the account of over \$27,000,¹³ which amount was considerably increased by Mr. Wilder's selective close-out scheme. See Opening Brief of Bertha Hecht, 26-32.

It is apparent that the commodities account was an integral part of the means used by Mr. Wilder to defraud plaintiff. Because her comprehension of commodities was "virtually nil", it was easier for him to generate commissions through the commodities account than the securities account.

Further, as Mr. Wilder's handling of plaintiff's commodities account went totally unsupervised (see *infra*, pp. 55-56), his fraudulent churning of plaintiff's account stood far less chance of being detected by Harris, Upham & Co. when effected through the com-

13. The Commodity Exchange Authority calculates this figure to be \$34,000. *Asa v. Wilder*, CEA Docket No. 154.

modities account. Had the excessive activity been confined to plaintiff's securities account, the rate of activity would have more than doubled¹⁴ and possibly raised questions from Harris, Upham & Co.'s supervisory personnel—as unconcerned though they were about supervision. Far safer and easier for Mr. Wilder to spread his generation of commissions from plaintiff over two accounts—one of which he knew his superiors entirely ignored.

The effect of the scheme upon Mrs. Hecht was the same regardless of which account was used, for both accounts were composed of her securities and the proceeds of those securities. The conversion of funds intended to be used for the purchase of securities or resulting from a sale of securities is a violation of the Federal Securities laws.¹⁵ It is no less of a violation to take the proceeds of securities, as here, and misappropriate them through taking commissions one is not entitled to. *Lorenz v. Watson*, 258 F.Supp. 724, 731 (E.D. Pa. 1966).

The commodities transactions and commissions were effected and generated "*in connection with*" the purchase and sale of securities and thus fall within the proscription of Rule 10b-5.

B.

PLAINTIFF'S COMMODITY ACCOUNT WAS ITSELF A "SECURITY" WITHIN THE MEANING OF THE FEDERAL SECURITIES LAWS

A commodities account which is managed and supervised by a broker is an "investment contract" and therefore a "security" within the meaning of Section 2(1) of the Securities Act of 1933 (15 U.S.C.A. § 77b(1)) and Section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C.A. § 78c(a)(10)).

14. Based upon the fact that commodity commissions totaled \$98,000 whereas commissions and mark-ups on securities transactions totaled \$91,000.

15. *Goodman v. H. Hentz & Co.*, 265 F.Supp. 440, 444-445 (N.D. Ill. 1967); *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 253 F.Supp. 359, 367 (S.D.N.Y. 1966); *Cooper v. North Jersey Trust Co. of N.J.*, 226 F.Supp. 972, 978 (S.D.N.Y. 1964) (and cases there cited).

Mabeu v. Reynolds & Co., 282 F.Supp. 423, 426 (S.D.N.Y. 1967)

SEC v. Commodity Brokerage Company, Inc., SEC Litigation Release No. 3636 (W.D. Pa. 1964) (C.T. 463-464)

Berman v. Orimex Trading, Inc., 291 F.Supp. 701 (S.D. N.Y. 1968)¹⁶

Cf. W. J. Abbott & Co., Inc. v. SEC, 276 F.Supp. 502, 505-506 (W.D. Pa. 1967)

Anderson v. Francis I. duPont & Co., 291 F.Supp. 705, 709 (D.Minn. 1968):

"It is clear that the arrangements that plaintiffs had with Hench were more nearly that of a 'discretionary account.' Hench was not a mere means of purchasing commodities as in *Sinva*. He was in complete control of the 'investment program' and all transactions in the market were at his discretion and it was this discretion upon which the plaintiffs relied. Therefore, these instruments are not taken out of the jurisdiction of this Court by the *Sinva* case."

Plaintiff's commodities account was completely controlled and operated on a discretionary basis by Mr. Wilder (see *supra*, pp. 15-18). It was, therefore, in and of itself a security over which the District Court had jurisdiction.

C.

PLAINTIFF HAD AN IMPLIED RIGHT OF ACTION UNDER THE COMMODITY EXCHANGE ACT TO RECOVER DAMAGES RESULTING FROM DEFENDANTS' WRONGFUL CONDUCT

The trial court recognized (283 F.Supp. at 437) that it has been held that violation of Section 4b of the Commodity Exchange Act (7 U.S.C.A. § 6b) gives rise to an implied right of action for damages.

16. Decided by the same judge who decided *Sinva*, which case he here distinguishes because of the *new element of control over the account by the broker*.

Goodman v. H. Hentz & Co., 265 F.Supp. 440, 446-447 (N.D. Ill. 1967)

Implied rights of action are to be implied unless the legislation evidences a contrary intention.

Brown v. Bullock, 194 F.Supp. 207, 224 (S.D.N.Y. 1961),
aff'd on other grounds, 294 F.2d 415 (2d Cir. 1961);
cited in *Wheeldin v. Wheeler*, 373 U.S. 647, 661, 662
(1963) (Brennan, J., dissenting)

It is appropriate that such an implied right of civil action for defrauded investors in commodities be recognized for one of the fundamental purposes of the Commodity Exchange Act is to "insure fair practice and honest dealing on the commodity exchanges" and Section 4b is a basic part of the Congressional effort designed to achieve that purpose (H. Rep. No. 421, 74th Cong., 1st Sess., pp. 1, 5).

Section 4b specifically provides that it shall be unlawful "in or in connection with" the making of any contract of sale of any commodity future for or on behalf of any person:

- (a) "to cheat or defraud or attempt to cheat or defraud such person;"
- (b) to make "any false report or statement" to such person; or
- (c) "willfully to deceive or attempt to deceive such person by any means whatsoever" in regard to such contract.

These prohibited acts are made crimes by Section 9 of the Act (7 U.S.C.A. § 13) and their violation may also result in disciplinary proceedings (7 U.S.C.A. § 12a).

The similarity of the language and structure of Section 4b to that of Rule 10b-5 is striking. Both contain three subsections¹⁷ whose prohibitions extend far beyond common law fraud or

17. Section 4b contains a fourth subsection not here important.

deceit—defendants' assertion to the contrary notwithstanding (H.U. Brief, 45).

Section 4b broadly prohibits cheating or deceiving "by any means whatsoever" and the breadth of this prohibition has been emphasized by the Commodity Exchange Authority in a disciplinary proceeding brought under the Commodity Exchange Act:

" 'Cheat' and 'defraud' include every kind of trick, device, artifice, or deception from false representation and intimidation to suppression and concealment of fact or information, used for the purpose of depriving another of his property or other known right contrary to the plain rules of common honesty. *State v. Gerich*, 138 Conn. 292, 83 A.2d 488, 490; *State v. Parker*, 114 Conn. 354, 158 A. 797, 800.

" 'It is established law that acts in violation of the fiduciary duties of an agent are regarded as fraudulent.' *Ramey v. Myers*, 159 C.A.2d 82, 323 P.2d 805, 808. Acts which tend to violate the 'fiduciary obligation' of an agent to a principal 'are considered, in law, as "frauds upon confidence bestowed."' *Myers v. Ellison*, 249 Ala. 367, 31 So.2d 353, 355. The 'vital principle [relating to agency] is good faith; without it the relation of principal and agent cannot exist; and so sedulously is this principle guarded, that all departures from it are esteemed frauds upon the confidence bestowed.' *Nagel v. Todd*, 185 Md. 512, 45 A.2d 326, 328."

In Re Douglas Steen, CEA Docket No. 104, Decision and Order dated October 11, 1962, pp. 17 et seq. For further extracts see C.T. 541-543.

The trial court found that defendants defrauded plaintiff by "clearly and unfairly" mishandling her account "as a fiduciary" (283 F.Supp. at 440) and by having "grossly and unfairly churned her account." 283 F.Supp. at 436. This conduct was held by the trial court to constitute a manipulative *device* or contrivance, a *device to defraud* and a *course of business which operates as a fraud and deception*. 283 F.Supp. at 433, 436.

These findings bring the case squarely within the statutory language and the above explanation of that language. Defendants' liability for the commodities transactions should also, therefore, be sustained under the Commodity Exchange Act.¹⁸

D.

A COMMODITY FUTURES CONTRACT IS A "SECURITY" WITHIN THE MEANING OF THE FEDERAL SECURITIES LAWS

This Court should also conclude that a commodity futures contract is a "security" within the meaning of former Section 25,008 of the California Corporation Code and is, therefore, a "security" as defined by the Federal Securities laws in that it is an "instrument commonly known as a 'security'" (15 U.S.C.A. § 78c(a)(10); 15 U.S.C.A. § 77b(1)).

This argument has been developed in detail in Plaintiff's Trial Memorandum of Law (C.T. 533-538).

E.

THE COMMODITIES TRANSACTIONS WERE ALSO EMBRACED WITHIN THE COURT'S PENDENT JURISDICTION

Plaintiff also invoked the pendent jurisdiction of this Court over the commodities transactions as part of her claim under California law for breach of fiduciary duty (C.T. 461, 532-533).

The power to determine pendent claims arises whenever there is a federal claim of substance and both claims derive from a common nucleus of operative facts. *United Mine Workers v. Gibbs*, 383 U.S. 715, 721-729 (1966). As the federal and state claims of plaintiff substantially overlap and basically involve a single fraudulent scheme and course of conduct, there was pend-

18. Contrary to defendants' position that for violations in commodities "More than a violation of Section 20(a) would be needed to bind Harris, Upham" (H.U. Brief, 45), Section 2 of the Commodity Exchange Act (7 U.S.C.A. § 4) imputes the act of an agent within the scope of his employment to the firm. *Goodman v. Hentz & Co.*, 265 F.Supp. 440, 447 (N.D. Ill. 1967).

ent jurisdiction over the claim of plaintiff that effecting unsuitable and excessive commodities transactions for her, breached defendants' fiduciary duties and obligations owed to plaintiff. *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 A.C.A. 759 (1968).

Because of the many common issues relating to plaintiff's claims regarding securities and commodities—e.g., plaintiff's needs and objectives, her relationship to Mr. Wilder, the manner in which the account was operated, the intention of defendants to generate commissions—the present case is one in which it “would ordinarily be expected” that all of the claims be tried in one judicial proceeding. *United Mine Workers of America v. Gibbs*, 383 U.S. 715, 725 (1966).

See also, *Errion v. Connell*, 236 F.2d 447, 454 (9th Cir. 1956); *Taussig v. Wellington Fund, Inc.*, 313 F.2d 472, 475-476 (3rd Cir. 1963):

“The leading cases on pendent jurisdiction hold that an actual right to relief under some federal statute need not be established to justify adjudication of the merits of a coupled common-law claim. . . . The common law claim must be dismissed only if the coupled federal contention is ‘plainly unsubstantial either because obviously without merit, or “because its unsoundness so clearly results from the previous decisions of this court as to foreclose the subject and leave no room for the inference that the questions sought to be raised can be the subject of controversy.”’ ”

Plaintiff's claim of securities churning is obviously not “plainly unsubstantial” so that pendent jurisdiction over the commodities transactions would here have been appropriate.

For all of the foregoing and alternative reasons, the trial court's assumption of jurisdiction over the commodities transactions in plaintiff's accounts should be affirmed.

THE TRIAL COURT PROPERLY FOUND THAT PLAINTIFF'S ACCOUNT HAD BEEN CHURNED IN VIOLATION OF THE FEDERAL SECURITIES LAWS

(H.U. Brief, 21-25, 28-29, 39-41, 41-63)

From the outset of this litigation, plaintiff's primary claim against defendants has been that they "churned" her account in violation of the Federal Securities laws. It is largely upon this claim that the trial court's decision is based.

Defendants challenge (H.U. Brief, 2, 39, 41, 51-52) what the SEC and this and other courts have repeatedly accepted—that churning violates the Federal Securities laws. Such a challenge is demonstrably without merit.

A.

RULE 10b-5 BROADLY PROHIBITS ANY TYPE OF MANIPULATIVE OR DECEPTIVE DEVICE

Rule 10b-5 makes unlawful *all* fraudulent activity regardless of "whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967). See also, *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961); Bromberg, *Securities Law: Fraud—SEC Rule 10b-5* (McGraw-Hill 1967), pp. 14-58.

Defendants misconstrue Rule 10b-5 when they assert that it is limited to cases of misrepresentation or misleading omission (H.U. Brief, 53). While subsection 2 does require a material misrepresentation or a misleading omission, the other two subsections of the Rule do not. *Mac Robbins & Co., Inc.*, 41 SEC 116, 117-118 (1962).

Even total silence violates Rule 10b-5 when a broker-dealer has a duty to disclose. Cady, Roberts & Co., 40 SEC 907, 910-917 (1961). See also, *Cochran v. Channing Corporation*, 211 F. Supp. 239, 243 (S.D.N.Y. 1962); *Brennan v. Midwestern United Life Ins. Co.*, 259 F.Supp. 673, 681-682 (N.D. Indiana 1966).

The Federal Securities laws are in large part directed at unethical practices of broker-dealers and impose upon them standards of conduct the violation of which is cause both for disciplinary proceedings by the SEC and private actions for damages.

Stockbrokers generally—and defendants here particularly because of the special relationship between Mr. Wilder and Mrs. Hecht—are in a fiduciary relationship to their customers and they impliedly represent that they will deal fairly and honestly with them.

The Securities Exchange Act is more than "a disclosure act" (H.U. Brief, 98) since it sets up standards of behavior and regulates conduct. The SEC has interpreted the congressional intent as having been to create "broad remedial provisions aimed at reaching misleading or deceptive activities." *Cady, Roberts & Co.*, 40 S.E.C. 907, 910 (1961). In any event, defendants failed in their duty to disclose.

Rule 10b-5 creates a duty in investment brokers to disclose which arises from their fiduciary relationship with clients.¹⁹ The "courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). A fiduciary must disclose *all* facts which he "should realize have or are likely to have a bearing upon the desirability of the transaction from the viewpoint of the principal." *Restatement (Second) of Agency*, § 390, comment a at 209 (1957). Cf. *Hughes v. SEC*, 174 F.2d 969, 976

19. "Rule 10b-5 fiduciary duties usually arise in two distinct factual contexts: the duty of officers or directors to corporations, and the duty of investment brokers and advisors to their clients. The courts have generally been most expansive in their application of 10b-5 to brokers and advisors since the regulation was most obviously directed at these parties. See, e.g., *O'Neill v. Maytag*, 339 F.2d 764, 769 (2d Cir. 1964). Fraud is often given a special meaning in actions against investment specialists, without common law limitations being applied." Comment, *Fiduciary Suits Under Rule 10b-5*, 1968 Duke L.J. 791, 792, n. 7. See also, *Moscarella v. Stamm*, 288 F.Supp. 453, 457-458 (E.D.N.Y. 1968).

(D.C. Cir. 1949). As the court below noted, Wilder failed in his duty "to frankly and fairly explain" to Mrs. Hecht, as "a naive customer dependent upon Wilder and on Harris, Upham" "basic considerations" regarding her account. 283 F.Supp. at 434.

Defendants were obligated, therefore, not only to refrain from churning and otherwise improperly handling plaintiff's account, but also to disclose to her that the management of her account was unsuitable in view of her investment requirements.

Defendants incorrectly contend that they cannot be held to have violated the Federal Securities laws because neither deception nor non-disclosure were found by the trial court (H.U. Brief, 33, 54). Even if deception is a necessary element of a Rule 10b-5 action, deception is not restricted to common law deceit but "may take the form of nonverbal acts" (*O'Neill v. Maytag*, 339 F.2d 764, 768 (2d Cir. 1964)) and deception is inherent in a claim of churning. *Lorenz v. Watson*, 258 F.Supp. 724, 731-732 (E.D. Pa. 1966); *Moscarella v. Stamm*, 288 F.Supp. 453, 458 (E.D. N.Y. 1968). See also, *Hartwell Corp. v. Bumb*, 345 F.2d 453, 456 (9th Cir. 1965).

Further, *the trial court did find non-disclosure of a number of "basic considerations" and also concluded that the excessive trading of plaintiff's account constituted a fraud and deception upon plaintiff in violation of the Federal Securities laws.* 283 F.Supp. at 432-433, 436.

It is clear, therefore, that not even considering the misrepresentations and omissions plaintiff alleged (C.T. 650-663, 695-710), her claims and the findings of the trial court established violations encompassed by Rule 10b-5.

B.

CHURNING IS A VIOLATION OF THE FEDERAL SECURITIES LAWS

Churning is "excessive trading for the purpose of producing commissions rather than acting on behalf of one's client" (*Lorenz*

v. Watson, 258 F.Supp. 724, 733, 731 (E.D. Pa. 1966)) and occurs whenever a stockbroker "who is in a position to determine the volume and frequency of transactions" in a customer's account abuses his position "for personal gain by frequent and numerous transactions disproportionate to the investment in the account." *Moscarella v. Stamm*, 288 F.Supp. 453, 457 (E.D.N.Y. 1968).

The trial court stated that churning "essentially involves a bad faith, fraudulent purpose of the broker to derive profit for himself by disregarding the interests of his customer." 283 F.Supp. at 433. See also, *Irish v. SEC*, 367 F.2d 637, 638 (9th Cir. 1966).²⁰

The judicial authorities supporting the trial court's conclusion that churning violates the Federal Securities laws are numerous.²¹

20. Contrary to defendants' assertion that the term "*churning*" is not itself used in any rule or regulation (H.U. Brief, 51), Rule 260.216.5 promulgated under the California Corporate Securities Law of 1968 reads as follows:

"Churning. The phrase 'manipulative, deceptive, or other fraudulent scheme, device, or contrivance' . . . include[s] any act of any broker-dealer or agent designed to effect with or for any customer's account with respect to which such broker-dealer or his agent or employee is vested with any discretionary power, or *with respect to which he is able* by reason of the customer's trust and confidence *to influence the volume and frequency of the trades, any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.*" (emphasis added)

21. Defendants refer (H.U. Brief, 54) to *Nash v. J. Arthur Warner & Co.*, 137 F.Supp. 615 (D.Mass. 1955) and *Carr v. J. Arthur Warner & Co.*, 137 F.Supp. 611 (D.Mass. 1955).

In those cases, the court denied recovery to "hard-headed" and sophisticated customers with business experience who alleged unlawful churning of their accounts. The *Nash* case involved four members of the same family who were quite aware of the transactions effected for their account and to whom *no* false representations of any kind were made. The plaintiff in *Carr* was "fully competent" and "fully advised" and the court expressly found *no breach of duty*.

Apparently no proof was presented nor claim made that the commissions generated by the alleged over-trading were of such magnitude that the firm's management was put on notice of the alleged impropriety. Nor does it appear that any claim was made based on a failure to supervise or breach of fiduciary duty.

- Lorenz v. Watson*, 258 F.Supp. 724, 730-731 (E.D. Pa. 1966)
- Moscarelli v. Stamm*, 288 F.Supp. 453, 457-458 (E.D.N.Y. 1968)
- Weiser v. Schwartz*, CCH Fed. Sec. L. Rep., para. 92,286 (E.D. La. 1968)
- Newkirk v. Hayden, Stone & Co.*, CCH Fed. Sec. L. Rep., para. 91,621 (S.D. Calif. 1965)²²
- Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 845-847 (E.D. Va. 1968)
- Leonard v. Colton*, CCH Fed. Sec. L. Rep., para. 92,284 (E.D. N.Y. 1968)
- Hersh v. SEC*, 325 F.2d 147 (9th Cir. 1963) (affirming *J. Logan & Co.*, 41 SEC 88 (1962))
- R. H. Johnson & Co. v. SEC*, 198 F.2d 690 (2d Cir. 1952)
- See generally, Comment, *Churning by Securities Dealers*, 80 Harv. L. Rev. 869 (1967)

The Securities Exchange Commission has said of these cases that: "The judgment appears to have rested in large part on the court's conclusion of fact that *the customers, rather than the securities firm involved, were responsible for the degree of activity in the account.*" SEC 22nd Ann.Rep., 1956-1957, p. 125 (emphasis added)

These cases present unique fact situations and are not here useful guides nor reliable precedents. Moreover, shortly after these civil cases had been decided, in the only recorded criminal action under the Federal Securities laws involving the fraudulent churning of customers' accounts, the same J. Arthur Warner & Co. defendants pleaded guilty, were fined and received suspended prison sentences. *United States v. J. Arthur Warner & Co.*, (D. Mass.) SEC Litigation Releases Nos. 910 (April 27, 1955), 920 (June 10, 1955). Cf. SEC 21st Annual Report 1955-1956, p. 109.

22. This case was decided under both Section 17(a) of the Securities Act and Rule 15c1-7 and not—as defendants claim—exclusively under Rule 15c1-7 (H.U. Brief, 55).

In defining and formulating the principles of churning, the above decisions have in part relied upon SEC decisions and SEC Rule 15c1-7. This rule prohibits effecting for a customer's account over which the broker has discretionary power "any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account."

A similarly worded prohibition is contained in Rule 435 of the New York Stock Exchange and Section 15(a) of the NASD Rules of Fair Practice (See Appendix C p. 16-17,11 *infra*) and the NASD Board of Governors has also expressly stated that "excessive activity in a customer's account, often referred to as 'churning' or 'overtrading' " violates a broker's "fundamental responsibility for fair dealing." NASD Manual, p. 2051 (Plaintiff's Exhibit 295).²³

The SEC has repeatedly held that churning by a broker is conduct which violates Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act, and Rule 10b-5.

Paine, Webber, Jackson & Curtis, SEC Securities Exchange Act Release No. 8500 (January 22, 1969)

Looper and Company, 38 SEC 294 (1958)

R. H. Johnson & Co., 33 SEC 180 (1952)

R. H. Johnson & Co., 36 SEC 467 (1955)

First Securities Corporation, SEC Securities Exchange Act Release No. 6497 (March 20, 1961)

Reynolds & Co., 39 SEC 902 (1960)

Shearson, Hammill & Co., CCH Fed. Sec. L. Rep., para. 77,306 (1964-1966 Transfer Binder, November 12, 1965), pp. 82,531-82,534

23. That the New York Stock Exchange prohibits churning refutes defendants' facile contention that churning cannot occur with listed transactions (H.U. Brief, 40). The "vice" of churning is not simply the "cost" of mark-ups or commissions but rather that it disregards the customer's best interests. The question of what damages result from this improper conduct is a separate one, although it is clear that there can be—and here were—damages going far beyond the "cost" of the commissions paid by the customer.

E. H. Rollins & Sons, Inc., 18 SEC 347, 380-382 (1945)

Norris & Hirschberg, Inc., 21 SEC 865, 894 (1946)

Behel, Johnsen & Co., 26 SEC 163 (1947)

J. Logan & Co., 41 SEC 88 (1962)

This wealth of authorities amply supports the trial court conclusion that churning is a manipulative device and contrivance, a device to defraud, and a practice and course of business which operates as a fraud and thus conduct which is prohibited by Section 10(b) and Rule 10b-5. 283 F.Supp. at 433.²⁴

C.

THE TRIAL COURT'S FINDINGS OF CHURNING ARE NOT CLEARLY ERRONEOUS

The trial court properly recognized (283 F.Supp. at 435) that the determination of whether an account has been churned is one of fact. *First Securities Corporation*, SEC Securities Exchange Act Release No. 6497 (March 20, 1961), p. 3. Churning is composed of two primary elements: (1) control or power over the account by the broker; and (2) a degree of activity inconsistent with the customer's requirements which indicates the broker's intention to derive profit for himself by disregarding the interests of his customer. Defendants have failed to demonstrate that the trial court's findings as to either of these elements was clearly erroneous.

1. THE TRIAL COURT PROPERLY FOUND THAT MR. WILDER CONTROLLED THE ACCOUNT

To establish liability for churning it is not necessary to show a formal discretionary account. All that need be demonstrated is that the broker controlled or had power over the account and

24. Churning also violates the fiduciary's duties owed by defendants to plaintiff under the law of California (*Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 A.C.A. 759 (1968)) and was asserted as a part of plaintiff's pendent claim and thus properly before the trial court although it failed to rule on it. Cf. 13 Cal.Jur.2d, Courts § 108. See Opening Brief of Bertha Hecht, 55-59.

the activity in it. *Norris & Hirschberg, Inc.*, 21 SEC 865, 890 (1946); *Moscarelli v. Stamm*, 288 F.Supp. 453, 457 (E.D.N.Y. 1968); *E. H. Rollins & Sons, Inc.*, 18 SEC 347, 380 (1945); Comment, *Churning by Securities Dealers*, 80 Harv. L. Rev. 869, 871-874 (1967).

The trial court here found that Mr. Wilder and Harris, Upham and Co. controlled plaintiff's account and were responsible for the excessive volume and frequency of transactions in it. 283 F.Supp. at 435. Defendants' only response to this finding is to simply assert that it is not supported by the evidence (H.U. Brief, 57).²⁵ This does not effectively challenge the finding which, in any event, is amply supported by the record. (See *supra*, pp. 15-18; Opening Brief of Bertha Hecht, 12-16; Plaintiff's Trial Memorandum of Fact (C.T. 611-612)).

2. DEFENDANTS ACTED IN BAD FAITH TO PROFIT THEMSELVES WHILE DISREGARDING MRS. HECHT'S INTERESTS

The determination of "whether or not excessive trading has occurred in a particular case must be based largely on the financial situation of the customer involved." *First Securities Corporation*, SEC Securities Exchange Act Release No. 6497 (March 20, 1961), p. 3.

a. Defendants Were Obligated to Treat Plaintiff's Account As An Investment Account

Mrs. Hecht's situation and needs required *that her account be handled as an investment account and defendants were obligated to so treat it.*

25. It is a non sequitur to state, as defendants do, that the account could not be discretionary because Harris, Upham & Co. does not accept discretionary accounts (H.U. Brief, 57). By the same reasoning, Harris, Upham & Co. could never commit any of the wrongs its supervisory rules prohibit.

Mrs. Hecht was an elderly widow of failing faculties whose sole source of income was the dividends received on her portfolio (R.T. 1898). It was her intention to live off the dividend income received on her securities. The securities were not to be sold as they had been in the Hecht family for many years and the account was to be managed on the same investment basis as her personal account at Walston & Co. had been managed by Mr. Hecht and the Walston registered representative. (R.T. 2388, 2459, 2620-2621, 2683, 2685, 2954-2957, 2975; C.T. 684-687).

When the customer is—as Mrs. Hecht was—elderly, dependent on the income from the investments and completely reliant upon her broker for advice, the duty of the broker under the Federal Securities laws is to treat the account as an investment account. *First Securities Corporation*, SEC Securities Exchange Act Release No. 6497 (March 20, 1961), p. 3. See also, *Behel, Johnsen & Co.*, 26 SEC 163, 165 (1947); *Powell & McGowan, Inc.*, 41 SEC 933, 935 (1964); *Norris & Hirshberg, Inc.*, 21 SEC 865, 890-891 (1946).

Further, there was here the special fiduciary relationship between Mr. Wilder and Mrs. Hecht which increased his and his employer's duties to fairly deal with Mrs. Hecht. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 193-194 (1963). Mr. Wilder and Harris, Upham & Co. also agree that a stockbroker owes to any customer the obligation of undivided loyalty which requires that he know the essential facts about the customer and make certain that any recommendations are suitable for the customer in light of his financial situation and needs (R.T. 2139-2141, 469-470, 473; Plaintiff's Exhibit 13; C.T. 673-674).

In the context of the present case, defendants were—as the NASD has explicitly stated (Opening Brief of Bertha Hecht, Appendix A, pp. 18, 20)—obligated to treat Mrs. Hecht's account as an investment account and to make only suitable rec-

ommendations to her.²⁶ *Anderson v. Knox*, 297 F.2d 702, 707-720 (9th Cir. 1961), cert. denied, 370 U.S. 915 (1962).

Nor is defendants' duty in this respect affected by the trial court findings of estoppel and waiver, even assuming that these findings were correctly made. *Estoppel and waiver are defenses which do not affect the definition or existence of a right but only its judicial enforcement. United States v. Chatham*, 298 F.2d 499, 501 (4th Cir. 1962).

Although the trial court has said that plaintiff is estopped to claim the full damages resulting from the improper management of her account, this does not affect the investment nature of plaintiff's account or defendants' duty to so treat it. Even where the account is claimed or even admitted to be a trading account the broker is still obligated to treat the account as called for by the customer's circumstances. *Norris & Hirschberg, Inc.*, 21 SEC 865, 890-891 (1946); *First Securities Corporation*, SEC Securities Exchange Act Release No. 6497 (March 20, 1961), p. 3.

The determination, therefore, of whether the activity in plaintiff's account was excessive should be considered in light of plaintiff's investment needs and situation.

3. THE VOLUME AND FREQUENCY OF TRANSACTIONS WAS EXCESSIVE AND INDICATES DEFENDANTS' INTENTION TO DISREGARD PLAINTIFF'S INTERESTS FOR THE SAKE OF THEIR OWN PROFIT

By any standards plaintiff's account was churned. Contrary to defendants' assertion (H.U. Brief, 57), the trial court did hold that "*even considered as a trading security and commodity account*" plaintiff's account was "*grossly and unfairly churned by Wilder for no reason other than to generate profits for the firm and indirectly for himself.*" 283 F.Supp. at 436 (emphasis added).

26. This obligation is also a part of the "suitability" rule of the NASD, for violation of which—plaintiff contends—there is an implied right of civil action. See Opening Brief of Bertha Hecht, 59-67.

This factual finding is convincingly supported by the record facts relied upon by the trial court (283 F.Supp. at 436) as well as others set forth elsewhere. See Opening Brief of Bertha Hecht, 16-32. Defendants do not refute these facts. That Mr. Wilder generated nearly 50% of his total commissions and close to one-third of the total commodity commissions for the San Francisco office from plaintiff's account is in and of itself sufficient documentation that defendants disregarded plaintiff's interests so as to profit themselves.²⁷

Although comparison of figures with those of other churning cases is of limited value as the determination of excessive activity is primarily dependent upon the facts of a particular case, such a comparison does show that the figures regarding plaintiff's account are comparable (C.T. 719-734). It should also be kept in mind that plaintiff's account was originally of much greater value than accounts in other cases and consisted of investment quality blue chip stocks of high income yield. This means that even had there been a much lower level of turnover than there was in fact, it still would have shown a disregard of Mrs. Hecht's interests for the benefit of the broker. Further, other churning cases lack the added ingredient here present of a tremendously high volume of commodities transactions which were wholly inappropriate and unsuitable for Mrs. Hecht.

One case which shows many similarities to the present case—including the fact that the broker churned the account, apparently without objection from the customer, for nearly six years—is *R. H. Johnson & Co. v. SEC*, 198 F.2d 690 (2d Cir. 1952).

27. Defendants' figure for the median amount earned by Harris, Upham & Co. from plaintiff's account (H.U. Brief, 60) ignores the commodities commissions, mark-ups on over-the-counter transactions, and the margin interest paid. The total amount taken out of the account by Harris, Upham & Co. was \$232,000 which is 44% of the original portfolio value of \$533,000 (283 F.Supp at 424, 436) or approximately 61½% of that value per year.

It should also be recognized that there is no such thing as "*the*" trading account which could serve as a standard of comparison to plaintiff's account. What is appropriate for one person—even assuming it is some type of trading—is not necessarily appropriate for another.

That Mrs. Hecht was an elderly widow entirely dependent upon the income from her portfolio affects what might appropriately be "traded" for her, even accepting that waiver and estoppel transformed her account from an investment account into a trading account. "Trading" would have had to be limited to efforts to improve the investment quality of her portfolio and to secure higher income yields from it. *Walter S. Grubbs*, 28 SEC 323, 329 (1948). Under any characterization of plaintiff's account, defendants were precluded from recommending and effecting transactions in commodities²⁸ and speculative, non-income producing or even "businessman risk" type of securities.

Thus, even if the account is viewed as a trading account, the overall volume and frequency of transactions indicate that defendants' interest in trading the account was not to aid Mrs. Hecht and meet her investment requirements, but rather—as the trial court found—to make profits for themselves.

Defendants' assertion (H.U. Brief, 59) that no expert testified that Mrs. Hecht's account was excessively traded ignores *the testimony of Mr. William P. Wentworth—an eminent investment advisor—that the commissions on security and commodity transactions, separately as well as combined, were excessive for one in Mrs. Hecht's circumstances* (R.T. 1953-1954). The primary factual determination is one of intention—whether defendants were acting to further their own interests or those of the customer.

28. Contrary to defendants' contention (H.U. Brief, 58), commodities are related to a customer's "needs and circumstances" when the customer has risk capital available to him. This does not apply to an elderly widow dependent upon the return on her securities for her livelihood.

This determination has been made by the trial court and must stand as it has not been shown to be clearly erroneous.²⁹

Defendants assert that as profits were realized in security transactions this raises doubts that defendants disregarded Mrs. Hecht's interests (H.U. Brief, 60). This assertion simply ignores that the trial court has found that defendants did so disregard plaintiff's interests. 283 F.Supp. at 434-436. Further, there was an overall realized loss in plaintiff's securities and commodities account (283 F.Supp. at 425) and an unrealized loss of over \$100,000 on the securities in plaintiff's account on March 31, 1964 (Defendants' Exhibit S-3; R.T. 1908-1910).³⁰

Even if there had been a gain, this would not preclude a finding of churning. *First Securities Corporation*, SEC Securities Exchange Act Release No. 6497 (March 20, 1961), pp. 3-4; *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 847 (E.D. Va. 1968).

Defendants deal separately with the question of churning of commodities (H.U. Brief, 61-63). As the trial court found (283 F.Supp. at 437) that the commodities account was commingled with the securities account and was merely an extension of it, the commodities activity is rightfully considered as an integral part of the total activity in plaintiff's account. In any event, the

29. Defendants also incorrectly contend (H.U. Brief, 58) that evidence was required to show that each security was traded without regard to the market. Churning depends upon the overall volume and frequency of transactions rather than upon individual transactions and that the broker honestly tried to benefit the customer through a particular transaction is irrelevant. The question is whether overall he disregarded the customer's interests by engaging in excessive activity.

30. The realized gains were partly attributable to the improper sale of the blue chip securities plaintiff received from her husband's estate. Realized gains damaged plaintiff by causing her to pay income taxes on them and to the extent the gains were not used for taxes, they were retained in the account and used by defendants for further purchases of securities and commodities. Plaintiff, thus, did not benefit from the realized gains.

same basic principles apply to churning either commodities or securities and the trial court has found that the commodities activity was excessive and in disregard of plaintiff's best interests. These findings are clearly substantiated by the evidence so that no specific response to defendants' argument regarding commodities is called for.³¹

IV

HARRIS, UPHAM & CO. WAS PROPERLY FOUND TO BE LIABLE FOR THE VIOLATIONS OF THE FEDERAL SECURITIES LAWS WHICH OCCURRED

(H.U. Brief, 25-26, 64-65)

The trial court found defendants liable for the mishandling and unfair churning of plaintiff's account and the conversions of the Itek and Colonial securities. 283 F.Supp. at 438-439, 442-443. The following discussion reviews the grounds on which the trial court found Harris, Upham & Co. liable as well as additional grounds supporting liability not referred to by the trial court.

A.

HARRIS, UPHAM & CO. IS LIABLE BECAUSE IT HAD KNOWLEDGE OF AND PARTICIPATED IN THE CHURNING AND OTHERWISE IMPROPER HANDLING OF PLAINTIFF'S ACCOUNT

Harris, Upham & Co.'s brief (pp. 64-65) suggests that the only possible ground on which it may be held liable is as a controlling person under Section 20(a) of the Securities Exchange Act. This argument ignores Harris, Upham & Co.'s direct participation in the improper management of plaintiff's account. This participa-

31. It is interesting to note that the commodity purchase and sale statement attached as an addendum to defendants' brief is from Hooker & Fay and not one of the quite different forms used by Harris, Upham & Co. Further, this addendum *represents a transaction effected while Mrs. Hecht was out of the country and which was improperly effected by Mr. Wilder at Hooker & Fay after he had become employed by Harris, Upham & Co.* (C.T. 601).

tion makes it unnecessary to reach the question of whether Harris, Upham & Co. is liable as a controlling person under Section 20(a). *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F.Supp. 104, 122-123 (W.D. Ark. 1949).

The trial court found that Harris, Upham & Co. did "*indirectly induce, participate in, approve and accept the benefits of what we have found to be the excessive trading of the account by Wilder.*" 283 F.Supp. at 439 (emphasis added).

This finding is amply supported by the record. Harris, Upham & Co. effected all the transactions in plaintiff's account and thus is the party responsible for the account being churned. As "reports of all orders" for Mrs. Hecht's account "passed over an officer's desk" at Harris, Upham & Co., it "knew of the excess trading and permitted it to continue" and is therefore responsible. *Newkirk v. Hayden Stone & Co.*, CCH Fed. Sec. L. Rep., para. 91,621 (S.D. Calif. 1965), p. 95,321. See also, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bockock*, 247 F.Supp. 373, 378-380 (S.D. Tex. 1965) where the court found participation by a firm arising from its branch manager's failure to discover an unsuitable transaction in an account and held that this failure was the proximate cause of the loss.

Not only did Harris, Upham & Co. fail to prevent Mr. Wilder from overtrading plaintiff's account, it actively *encouraged him* to do so—as the trial court found (283 F.Supp. at 439)—*by rewarding him with bonuses and salary raises because of the commissions generated from plaintiff's account.* Conversely, it punished him for losing the account in 1964 by cutting his salary by \$400 a month (R.T. 1497-1498; Plaintiff's Exhibit 233). See also, Plaintiff's Trial Memorandum of Fact (C.T. 622-627, 596-600).

As one court has observed:

"... considerable injury to the investing public is not only possible but inevitable when a salesman is compensated in

direct proportion to the volume of transactions he handles, and his activities go unsupervised."

Lorenz v. Watson, 258 F.Supp. 724, 733 (E.D. Pa. 1966)
(emphasis added)

Harris, Upham & Co. further participated in the fraud committed on plaintiff by failing to supervise Mr. Wilder and his handling of Mrs. Hecht's account, as is detailed in the following subsection.

A failure to supervise constitutes direct participation in the fraud and the firm itself is to be held primarily liable to the customer injured by its own failure. *Lorenz v. Watson*, 258 F.Supp. 724, 733 (E.D. Pa. 1966); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bockock*, 247 F.Supp. 373, 378-380 (S.D. Tex. 1965); *Goodman v. H. Hentz & Co.*, 265 F.Supp. 440, 445 (N.D. Ill. 1967). See also, *R. H. Johnson & Co. v. SEC*, 198 F.2d 690, 696-697 (2d Cir. 1952); *Paine, Webber, Jackson & Curtis*, SEC Securities Exchange Act Release Nos. 8500, p. 6 (January 22, 1969; 15 U.S.C.A. § 78o (b) (5) (E)).

The SEC has stated that brokers are responsible for their employees' improper acts since "a firm can only act through its employees and agents, and the willful violations of its employees in the course of their employment must be considered the willful violations of the firm." *Sutro Bros. & Co.*, 41 SEC 470, 479 (1963).

The SEC has also held that a failure to supervise constitutes participation in misconduct and that "willful violations are committed not only by the person who performed the misconduct but also by those who did not perform their duty to prevent it." *Reynolds & Co.*, 39 SEC 902, 916-917 (1960). See also, *R. H. Johnson & Co.*, 36 SEC 467, 486-487 (1955) (failure to prevent churning); *E. H. Rollins & Sons, Inc.*, 18 SEC 347, 391 (1945); *Bond & Goodwin, Inc.*, 15 SEC 584, 601 (1944).

Harris, Upham & Co. was, therefore, properly found to be primarily and directly liable for its misconduct in handling plaintiff's account.

B.

HARRIS, UPHAM & CO. IS LIABLE BECAUSE OF ITS INADEQUATE SUPERVISION

Defendants assert (H.U. Brief, 65) that "the court did not find inadequate internal supervision". The trial court opinion, however, states that: "The court finds and concludes from the evidence that defendant Harris, Upham *did not maintain a reasonably adequate system of internal supervision and control.*" 283 F.Supp. at 439 (emphasis added).

1. A FIRM WHICH DOES NOT ADEQUATELY SUPERVISE IS LIABLE FOR THE MISCONDUCT OF ITS EMPLOYEES

A failure to supervise, as noted above, constitutes direct participation in the wrong and thereby makes the firm primarily liable.³²

Further, the fact that Harris, Upham & Co. chose not to present proof of adequate supervision (R.T. 3846) means that it did not meet its affirmative burden under Section 20(a) of the Securities Exchange Act to demonstrate that it acted in good faith and did not directly or indirectly induce the violation complained of. *Lorenz v. Watson*, 258 F.Supp. 724, 732-733 (E.D. Pa. 1966); *Goodman v. H. Hentz & Co.*, 265 F.Supp. 440, 445 (N.D. Ill.

32. Harris, Upham & Co. has recognized the importance of its obligation to supervise:

"... what we do and how well we do it is not our concern alone. There are others. Well over 100,000 clients, plus members of their families, are affected by our management abilities. *We are deeply conscious that whatever we do can have fairly widespread impact* ...

"Even though at Harris, Upham, supervision is delegated from the policy committee right down to the Registered Representative *responsibility ultimately travels in only one direction, up.*" Address by Henry U. Harris, Jr., Plaintiff's Exhibit 5, pp. 52, 59 (emphasis added).

1967); *Smith v. Bear*, 237 F.2d 79, 88 (2d Cir. 1956); *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F.Supp. 104, 122-124 (W.D. Ark. 1949).

The trial court has here found inducement and lack of good faith (283 F.Supp. at 439) and defendants have failed to show that these findings are clearly erroneous.

2. THE TRIAL COURT FINDINGS OF INADEQUATE SUPERVISION ARE NOT CLEARLY ERRONEOUS

As defendants present none of the facts bearing on the issue of supervision, their attack on the court's findings of inadequate supervision should be rejected out of hand.³³

In any event, Harris, Upham & Co.—as its counsel admitted (R.T. 3846)—had the burden of going forward with the evidence to prove adequate supervision. It chose, however, to rest on the evidence presented by plaintiff.

The court has summarized (283 F.Supp. at 438-439) some of that evidence which demonstrates the industry standards for supervision with which Harris, Upham & Co. failed to comply.

In addition to these facts, the record discloses the following:

1. *Mr. Wilder's commodities activities*—as the Harris, Upham & Co. commodities manager for Northern California—*went entirely without supervision* both in San Francisco and in the main office in New York. Mr. Mejia never even looked at the commodities monthly statements. (R.T. 429, 1438-1441; C.T. 817-819).

33. It is interesting to note that defendants only response to the court's findings is to surmise what might have happened had they properly supervised (H.U. Brief, 65). What is important, however, is not what Harris, Upham & Co.'s supervisory memoranda require of its personnel or what might have happened if someone had talked with Mrs. Hecht, but what, in fact, Harris, Upham & Co. did to supervise Mr. Wilder and his handling of Mrs. Hecht's account (C.T. 477-480). *The trial court found that the firm "did not enforce with any reasonable diligence such system as it did maintain."* 283 F.Supp. at 430 (emphasis added).

2. *No supervisory steps were taken to insure that Mrs. Hecht met Harris, Upham & Co.'s own standards which required that commodities accounts not be opened for any customer unless*

"The R.R. [registered representative] [is] absolutely certain the customer understands the perils of commodity markets, has a working acquaintance with the commodity he will trade and that he will trade on intelligent information—not on 'tips' " (Plaintiff's Exhibit 236).

Specifically, a commodities account was not to be opened for a woman unless she had "sufficient experience and knowledge of commodity trading" including the risk involved (Plaintiff's Exhibit 236; James F. Burns Deposition, 84-85).

3. *No question was ever raised by any supervisor as to the propriety of having an elderly naive widow entirely dependent upon her dividend income trading commodities to the extent that almost one-third of the total commodity revenue for the San Francisco office came from her account* (R.T. 1544; George U. Harris Deposition, 14).

4. *Mr. Mejia did not fulfill his duty of determining plaintiff's investment needs and objectives nor did he ever meet her, talk to her, write to her, or invite her to his office. Further, Harris, Upham & Co. never had its research department review her large account.* (R.T. 429-431, 468-471, 892).

5. *Mr. Mejia assumed plaintiff's account was a trading account and never found anything unusual in her account. The information he did have³⁴ on this new account of a "retired widow" came from Mr. Wilder—a new employee—and no check on this information was ever made* (R.T. 248-251, 434-435; C.T. 605) although Harris, Upham & Co. was required to (C.T. 608; Opening Brief of Bertha Hecht, Appendix A, pp. 25-26).

34. When the complaint was filed, Mr. Mejia told a newspaper man that he knew very little about the account (R.T. 3376-3377; Plaintiff's Exhibit 300).

6. *Mr. Mejia admitted to his lack of familiarity with many of the securities in plaintiff's account* (R.T. 673-685, 568-576, 581-582, 925-928, 910-915) so that his cursory review of her monthly statements—supposedly designed to see that the transactions were appropriate and suitable for her—was of little value (R.T. 470-473; Henry U. Harris, Jr. Deposition, 16-17; C.T. 816-821).

The evidence is, therefore, more than ample to support the trial court's findings of inadequate internal supervision. Had Harris, Upham & Co. properly supervised, it would have, at a minimum, informed itself as to plaintiff's investment requirements, questioned Mr. Wilder about the excessive activity and the purchases of non-income producing and speculative holdings in plaintiff's account and sought an explanation. This it failed to do and it must bear the consequences.³⁵

C.

HARRIS, UPHAM & CO. IS LIABLE BECAUSE IT RATIFIED MR. WILDER'S CONDUCT

Harris, Upham & Co. not only accepted and retained the benefits of Mr. Wilder's improper conduct—the margin interest and commissions paid by plaintiff—but it also asserted throughout the litigation that in handling Mrs. Hecht's affairs at Harris, Upham & Co. Mr. Wilder always acted in good faith and "meticulously observed and discharged all his duties and obligations to plaintiff" (R.T. 3596-3597; C.T. 19-20). For further facts demonstrating ratification by Harris, Upham & Co., see Plaintiff's Memorandum After Trial of Law and Facts on Damages (C.T. 822-826).

35. Harris, Upham & Co. was obviously more concerned about sales than supervision. Thus, it rewarded Mr. Wilder with bonuses and salary increases for churning plaintiff's account while reducing his salary by \$400 a month when the account was transferred. 283 F.Supp. at 439; Plaintiff's Exhibit 233. See also, Harris, Upham & Co. Memorandum #66 (Plaintiff's Exhibit YYYY-2) which stresses the need for "smart merchandising efforts" (C.T. 598-599).

The retention of an employee by a firm with knowledge or the opportunity to learn of the employee's wrongful conduct ratifies the wrongful acts and makes the firm liable for them. 2 Cal. Jur. 2d, *Agency*, pp. 760-761; See also, cases discussed at C.T. 826-828.

Nor can the principal retain the benefits from a fraudulent transaction without also subjecting himself to liability for the act. *Blackburn v. Dean Witter & Co.*, 201 Cal. App. 2d 518, 522 (1962); *Reusche v. California Pac. Title Ins. Co.*, 231 Cal. App. 2d 731, 737 (1965).

Harris, Upham & Co. has not repudiated Mr. Wilder's fraudulent conduct and has retained the commissions and interest paid by plaintiff resulting from his improper conduct. It has, therefore, ratified his conduct.

D.

HARRIS, UPHAM & CO. IS ALSO LIABLE BECAUSE MR. WILDER WAS ACTING WITHIN THE SCOPE OF HIS EMPLOYMENT IN MISHANDLING PLAINTIFF'S ACCOUNT

Defendants have admitted that in handling Mrs. Hecht's securities and commodities accounts at Harris, Upham & Co. Mr. Wilder was "acting as an agent for Harris, Upham & Co. and within the scope of his employment" (Plaintiff's Exhibit 192-1, p. 66). Harris, Upham & Co. is, therefore, liable for the fraudulent acts committed by Mr. Wilder in handling her account based upon the general principles of respondeat superior.

1. LIABILITY UNDER RESPONDEAT SUPERIOR IS NOT DISPLACED BY SECTION 20(a)

Section 20(a) of the Securities Exchange Act was not intended to displace liability under established principles of agency but rather to impose liability in situations where it might not attach under the common law. *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F.Supp. 104, 122-123 (W.D. Ark. 1949). See also, *The Johns Hopkins University v. Hutton*, CCH Fed. Sec. L. Rep.,

para. 92,268 (D. Md. 1968), p. 97,284 (agency principles apply to stockbroker under Securities Act of 1933).

There is no suggestion in the legislative history that Congress contemplated that Section 20(a) could be invoked to shield broker-dealers from responsibility for the wrongful acts committed by their employees within the scope of employment. As the general purpose of the legislation was to provide investors with protections beyond those then available, it is illogical to restrict an employer's liability to those situations coming within Section 20(a). This construction would provide *less* protection to defrauded investors than state law, thereby defeating the general "remedial purposes" of the Federal Securities laws which are to be interpreted "so as to carry out in particular cases the generally expressed legislative policy."³⁶ *SEC v. Joiner Corp.*, 320 U.S. 344, 351 (1943). See also, *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963).

In an action brought under Rule 10b-5 it has been noted that:

"Under common law principles, a principal is liable for the deceit of his agent committed in the very business he was appointed to carry out. This is true even though the latter's specific conduct was carried on without knowledge of the principal."

Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968)

It is irrelevant whether this language means that respondeat superior applies without regard to Section 20(a)—as plaintiff contends—or whether it means that the burdens imposed by Section 20(a) on a controlling person to show good faith and lack of inducement of the improper act cannot be met when the principal is liable under the law of agency. The result is the same in either case—the employer is liable when the employee acts within the scope of his employment.

36. The SEC has supported this position in an amicus curiae brief filed with the Supreme Court in *Kamen & Co. v. Paul H. Aschkar & Co.*, 382 F.2d 689 (9th Cir. 1967), cert. granted, 390 U.S. 942 (1968).

Finally, Section 2 of the Commodity Exchange Act (7 U.S.C.A. § 4) imputes the act of an agent within the scope of his employment to the firm. *Goodman v. H. Hentz & Co.*, 265 F.Supp. 440, 447 (N.D. Ill. 1967).

Plaintiff requests this Court to affirm the trial court's finding that Harris, Upham & Co. is liable on each of the above grounds.

V

PLAINTIFF WAS NOT BARRED BY ESTOPPEL, WAIVER OR LACHES FROM RECOVERING A FULL MEASURE OF THE DAMAGES SHE SUSTAINED

(H.U. Brief, 17-21, 45-51, 97-105)

Defendants do not adequately respond to plaintiff's arguments that both as a matter of law and on the facts of this case, plaintiff cannot be held to be barred by estoppel, waiver or laches from recovering all the damages she suffered (Opening Brief of Bertha Hecht, 32-44). Plaintiff's and defendants' contentions on this issue are succinctly set forth by the trial court (283 F. Supp. at 427-428) which attempted to resolve the issue by effecting a compromise (283 F. Supp. at 429-430). As a result, it is submitted that the trial court improperly applied the law of estoppel to the facts of this case.

A.

ESTOPPEL³⁷

1. ESTOPPEL IS INAPPLICABLE AS A MATTER OF LAW

No rebuttal is found in defendants' brief to the applicability of the principle that the defense of estoppel is only "to be applied against wrongdoers, not against the victim of a wrong." Roberts v. Roberts, 81 Cal. App. 2d 871, 881 (1947). This principle arises from the fact that estoppel is an equitable defense which

37. This section equally applies to laches as it requires the same showing as for estoppel. *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568, 570-571 (9th Cir. 1964).

cannot be invoked by a defendant with unclean hands. As the trial court found that defendants defrauded plaintiff, as a matter of law it "is elementary that one who is guilty of fraud cannot urge estoppel (or waiver) against the other party . . . for the purpose of making his fraud effective." *McDaniel v. United States*, 196 F.2d 291, 294 (5th Cir. 1952). See also *John Hancock Ins. Co. v. Markowitz*, 62 Cal. App. 2d 388, 408 (1944).³⁸

It would be inappropriate to apply the doctrine of estoppel to protect defendants' and their ill-gotten gain from the full consequences of their misdeeds, for one who "engages in a fraudulent scheme forfeits all right to protection, either at law or in equity." *Kansas City Operating Corporation v. Durwood*, 278 F.2d 354, 357 (8th Cir. 1960). See also, *Cook v. Ball*, 144 F.2d 423, 437-438 (7th Cir. 1944).

To have successfully established estoppel defendants would have had to prove that they had acted in good faith. The proof—and the finding of the trial court—was that defendants acted in bad faith and breached their fiduciary duty; and they cannot, therefore, rely upon a claim of estoppel. *Automatic Paper Machinery Co. v. Marcalus Mfg. Co.*, 147 F.2d 608, 613 (3rd Cir. 1945).

Further, *estoppel cannot be relied upon as "the means of successfully avoiding the requirements of legislation enacted for the protection of a public interest."* *Scott Paper Co. v. Marcalus Mfg. Co.*, 326 U.S. 249, 257 (1945); *Hampton v. Paramount Pictures*

38. A plaintiff who has been defrauded should not be denied relief "on the ground, forsooth, that he did not discover the fact that he had been cheated as soon as he might have done." *Rutherford v. Rideout Bank*, 11 Cal. 2d 479, 485-486 (1938). A person is entitled "to act upon the presumption that there exists no intention to cheat or defraud him." *Laraway v. First Nt. Bk. of LaVerne*, 39 Cal. App. 2d 718, 728 (1940).

Corp., 279 F.2d 100, 104 (9th Cir. 1960); *James Talcott, Inc. v. Carder*, 300 F.2d 654, 667 (5th Cir. 1962).³⁹

As Harris, Upham & Co. failed to live up to the standards of supervision required by the nature and operation of the securities industry (283 F. Supp. at 438-439), it has violated the duties imposed upon it by the Federal Securities laws. *Lorenz v. Watson*, 258 F. Supp. 724, 733 (E. D. Pa. 1966); *Reynolds & Co.*, 39 SEC 902, 916-917 (1960). Harris, Upham & Co.'s own peers⁴⁰ have found that defendants "had a duty to treat [Mrs. Hecht's] portfolio as an investment account" and to determine her needs and objectives (Opening Brief of Bertha Hecht, Appendix A, pp. 18, 27). Harris, Upham & Co.'s failure to fulfill these concomitant duties prevents it from relying upon any claim of estoppel by reason of Mrs. Hecht's alleged assumption of risk and acquiescence in the handling of her account.

2. THE FACTUAL ELEMENTS NECESSARY TO ESTABLISH AN ESTOPPEL WERE NOT PROVEN (OPENING BRIEF OF BERTHA HECHT, 33-36)

The party relying on estoppel must prove strictly each of the necessary elements by clear, convincing and satisfactory evidence and if findings are not made on each of the separate elements an appellate court cannot permit a claim of estoppel to stand. *Cedar Creek Oil & Gas Co. v. Fidelity Gas Co.*, 249 F.2d 277, 281 (9th Cir. 1957), cert. denied, 356 U.S. 932 (1958); *James Talcott, Inc. v. Associates Discount Corp.*, 302 F.2d 443, 446 (8th Cir. 1962); 18 Cal. Jur. 2d, *Estoppel*, § 14.

39. We respectfully submit that waiver and estoppel contravene the statutory policy of the Federal Securities laws and cannot be allowed. *Brooklyn Savings Bank v. O'Neil*, 324 U.S. 697, 705 (1944). See SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1968) ("... The Securities law should be interpreted as an expansion of the common law ... to effectuate the broad remedial design of Congress ...").

40. The NASD Business Conduct Committee which heard and determined the matter was composed of six experienced and qualified broker-dealers from national and local firms who were assisted by a professional staff and the NASD's Associate General Counsel. See Opening Brief of Bertha Hecht, Appendix A, pp. 1-2.

These elements were ignorance of the true facts and detrimental reliance on the part of Harris, Upham & Co. and knowledge and intentional conduct on the part of Mrs. Hecht.⁴¹

Ignorance of the True Facts

The trial court could not and did not find that defendants were ignorant of the true facts regarding the nature and character of plaintiff's investment requirements. In fact, the trial court found defendants were on notice that plaintiff was "a retired 'widow' expecting to receive her dividend checks monthly." 283 F. Supp. at 439. This finding is supported by the record (C.T. 602-603). Moreover, it was defendants' duty as skilled investment brokers to know that Mrs. Hecht was an elderly retired widow totally dependent upon the income from her account for her survival and was relying upon them for the suitable management of her account (C.T. 513-516, 606-608).

Since defendants had the duty to know these facts, were in a position to know them, and did know them, they cannot assert a claim of estoppel. *Gaylord v. CIR*, 153 F.2d 408, 416 (9th Cir. 1946).

Nor can defendants claim that they were ignorant of the facts found by the court—that plaintiff's original portfolio was being traded, that the account was being handled by Mr. Wilder in a manner different from its handling by her former broker (i.e., as "a relatively inactive investment type account") and that the account was being actively traded in commodities. 283 F.Supp. at 429. Defendants admit their awareness that plaintiff's account was managed as a trading rather than an investment account and that such management was "perhaps contrary to her needs and circumstances and her claimed objectives" (H.U. Brief, 100).

41. *Hampton v. Paramount Pictures Corp.*, 279 F.2d 100, 104 (9th Cir. 1960); 18 Cal. Jur. 2d, *Estoppel*, §§ 5-12.

Defendants, therefore, failed to establish an essential element of estoppel, and the trial court's failure to find that element as a fact is fatal.

Detrimental Reliance

The trial court made no finding that defendants detrimentally relied upon plaintiff's conduct, i.e., that defendants were misled to their "prejudice" or "altered" their position. Southern General Ins. Co. v. O'Keefe, 275 F. Supp. 107, 110 (D. Md. 1967).

"The vital principle" of estoppel, as recognized by this Court, "is that he who by his language or conduct *leads another to do what he would not otherwise have done, shall not subject such person to loss or injury by disappointing the expectations upon which he acted.*" *First National Bank of Portland v. Dudley*, 231 F.2d 396, 400-401 (9th Cir. 1956) (emphasis added). See also, *Walker v. Lightfoot*, 124 F.2d 3, 6 (9th Cir. 1942).

The record before this Court is barren of any proof of detrimental reliance by defendants, let alone any misleading conduct by plaintiff which led them to do what they otherwise would not have done. It is clear that unless there is a showing of such prejudice there is no basis for the application of the doctrine of estoppel "which is predicated upon injury resulting from the conduct of the parties." *In re Bastanchury Corp.*, 66 F.2d 653, 659 (9th Cir. 1933), cert. denied sub nom., *Turner v. John Deere Plow Co.*, 290 U.S. 700 (1933). The trial court's finding that plaintiff is estopped from claiming \$835,000 as her damages arising from the unsuitable investments effected for her account by defendants (283 F.Supp. at 429-430) is, therefore, clearly erroneous and should be reversed. *Bach v. Perkins*, 223 F.2d 251 (9th Cir. 1955), cert. denied, 350 U. S. 918 (1955).

Plaintiff's Knowledge and Intentions

The trial court did not find that plaintiff intended Harris, Upham & Co. to act in any particular fashion, although it does conclude that she "permitted Wilder and his firm to continue handling the account" in reliance upon her "apparent acquiescence." 283 F. Supp. at 429.

"Apparent acquiescence"—the only conduct of plaintiff referred to by the trial court—will not support a finding of estoppel in the absence of false representation, concealment or misleading omission of material facts with full knowledge, or inexcusable wrong, for estoppel is to be applied only to prevent actual or constructive fraud. *Sidebotham v. Robinson*, 216 F.2d 816, 829 (9th Cir. 1954); *Grand Trunk Western R. Co. v. H. W. Nelson Co.*, 116 F.2d 823, 836 (6th Cir. 1941).

Although in some circumstances silence or acquiescence may work an estoppel, it is necessary that such "conduct" amount to bad faith and the party to be estopped must be guilty of moral turpitude. *Codell v. American Surety Co.*, 149 F.2d 854, 856 (6th Cir. 1945); *United States v. Hal B. Hayes & Associates, Inc.*, 221 F. Supp. 260, 265 (N.D. Calif. 1963).

The trial court did not find—nor could it have upon the record—that Mrs. Hecht's "apparent acquiescence" amounted to bad faith, demonstrated moral turpitude, or resulted in a fraud upon defendants. To the contrary, the bad faith and fraud *emanated* from defendants.

It is only when there is a duty to speak that silence can effect an estoppel for the silence must be both wrongful and misleading. The mere opportunity to speak is insufficient. *Van Antwerp v. United States*, 92 F.2d 871, 875-876 (9th Cir. 1937); *Codell v. American Surety Co.*, 149 F.2d 854, 857 (6th Cir. 1945); *McNamara v. Miller*, 269 F.2d 511, 514 (D.C. Cir. 1959).

Mrs. Hecht owed no obligation or duty to defendants to inform them as to how they should best manage her account to meet her investment requirements. The duty to prevent misconduct rests with the perpetrator, not with the victim.

The trial court held that *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568 (9th Cir. 1964) barred plaintiff's claim of unsuitability since it read that case as establishing the proposition that estoppel by conduct exists when there is a knowledgeable assumption of "ordinary" risks of profit and loss. We respectfully submit that the court misread and misapplied that case to the facts of this case. See Opening Brief of Bertha Hecht, 37-44.

The trial court's factual conclusion was that Mrs. Hecht "knew" her account at Harris, Upham & Co. was "a trading account in securities and a speculative account in commodities." 283 F.Supp. at 430. The trial record only lends support to the conclusion that Mrs. Hecht eventually had knowledge of the fact that Mr. Wilder had opened and operated an account in her name at Harris, Upham & Co. (R.T. 2401-2405; C.T. 398, 601ff.) and that he told her that "it would be advisable to use the surplus [from accumulated dividends] of some of the money in [her] account and put it in commodities" (R.T. 2400). We submit, however, that the trial record does not support the conclusion that (1) Mrs. Hecht knew her account was either a *trading* or a *speculative* account in any respect or was being operated in any way which was unsuitable for her in light of her particular investment needs and objectives, or (2) that Mrs. Hecht knowingly or intentionally authorized or acquiesced in the handling of her account as a "trading" account. (R.T. 2388, 2459, 2620, 1224, 1506).

It is clear that whatever Mrs. Hecht's quantitative knowledge of the facts may have been, her qualitative appreciation and understanding of those facts was vastly restricted in scope and limited in depth (C.T. 580-585).

A review of Mrs. Hecht's actual "knowledge" and actual "conduct" demonstrates that: (a) she never gave or intended that Harris, Upham & Co. act upon any "permission" as to the manner in which her account was to be managed but rather trusted in Mr. Wilder to look after her portfolio and do what was right for her; (b) she never had adequate knowledge of the operation of her account as all her account papers were continually removed from her possession by Mr. Wilder (R.T. 1338, 1775, 2964), and she was misled through inadequate account documents (Opening Brief of Bertha Hecht, 39-42; C.T. 651-652; R.T. 30, 245-247, 567-568, 1773-1775), false summaries of the activity in her account (Opening Brief of Bertha Hecht, 14-15, 28-32; C.T. 666-672, 695-711), and a selective close-out scheme (Opening Brief of Bertha Hecht, 26-28); and (c) she never conducted herself in any manner which intentionally misled defendants to their injury.

B.

WAIVER

To prove that plaintiff impliedly waived⁴² her legal rights under the Federal Securities laws, defendants were required to show either a clear, unequivocal and decisive act by her evidencing a purpose to abandon or waive those rights or acts amounting to an estoppel. *Pacific States Corporation v. Hall*, 166 F.2d 668, 671 (9th Cir. 1948). We respectfully submit that defendants not only failed to sustain their burden of strictly proving the necessary elements of estoppel but also failed to prove—nor did the trial court find—that Mrs. Hecht committed any decisive act showing her intention to waive her legal rights.

This Court has emphasized that waiver can be found only when it is evidenced by *express intentional conduct* and only after the party *has actual and full knowledge of the rights he is waiving*.

42. Express waiver is neither claimed nor present.

Royal Air Properties, Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1964). See also, Opening Brief of Bertha Hecht, 36-39.

The only "conduct" relied upon by the trial court to evidence waiver is plaintiff's *failure to object* to defendants' improper management of her account. Such a failure to object does not constitute "*an intentional relinquishment of a known right.*" *United States v. Chichester*, 312 F.2d 275, 282 (9th Cir. 1963) (emphasis added).

In any event, waiver can only be proven by clear and convincing evidence (*Anderson v. Tway*, 143 F.2d 95, 102 (6th Cir. 1944)) and if "intention to waive is to be implied from conduct, the conduct should speak the intention clearly." *Bankers Trust Co. v. Pacific Employers Ins. Co.*, 282 F.2d 106, 111 (9th Cir. 1960), cert. denied, 368 U.S. 822 (1961). See also, *Pacific States Corporation v. Hall*, 166 F.2d 668, 671 (9th Cir. 1948); *Yates v. American Republics Corp.*, 163 F.2d 178, 180 (10th Cir. 1947).

When a waiver is manifested by actions, "*such actions must be inconsistent with any other intention than to waive.*" *Caterpillar Tractor Co. v. Collins Machinery Co.*, 286 F.2d 446, 451-452 (9th Cir. 1960) (emphasis added). See also, *Buffum v. Chase Nat. Bank of City of N.Y.*, 192 F.2d 58, 61 (7th Cir. 1951), cert. denied, 342 U.S. 944 (1952) (conduct must so manifest waiver that "no other reasonable explanation of [the] conduct is possible"); *Rockwell v. United States Fidelity & Guaranty Co.*, 137 F. Supp. 317, 318-319 (M.D. Pa. 1955) (the act must be "irreconcilably repugnant" to the legal right now asserted).

Mrs. Hecht's "apparent acquiescence" does not meet these standards. Mrs. Hecht's intention was that her account be kept basically intact and managed as an investment account in the same manner her relatively inactive Walston & Co. investment account was managed by Mr. Hecht and Mr. Ernest Fairey. This would have permitted her to live off the dividend income. (R.T. 2954-2957; C.T. 684-687).

Even if, contrary to her intention, defendants had understood plaintiff's silence to be a waiver, the "*mere fact that the other party is mistakenly led to believe there's been a waiver is not enough unless that party relies thereon to his detriment*," in which case there's an estoppel." *Caterpillar Tractor Co. v. Collins Machinery Co.*, 286 F.2d 446, 452 (9th Cir. 1960) (emphasis added).

The second major element of waiver—which must be found in addition to an intention to waive—is that the plaintiff "*acted with full knowledge of his rights*." *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568, 571 (9th Cir. 1964). A waiver is not effective unless it is "intelligently and competently given." *Griffith v. Rhay*, 282 F.2d 711, 717 (9th Cir. 1960), cert. denied, 364 U.S. 941 (1961).

The setting of this case *precludes* the finding of any waiver in favor of defendants. In the context of plaintiff's limited understanding and defendants' deliberate concealment and failure to disclose the facts during the seven year period, it would be highly unreasonable and unjust to hold that plaintiff waived *any* of her rights under the Federal Securities laws merely because she gave the management of her account over to defendants and did not complain of the improper management of that account until it was called to her attention in 1964.

In short, it cannot be said that a woman of Mrs. Hecht's limitations who completely relied upon and was dominated by Mr. Wilder, had actual knowledge of her rights under Rule 10b-5 prior to March 1964 so that she was in a position to waive those rights. Even if plaintiff could be said to have been negligent—or even grossly negligent—in not informing herself of the actual condition of her account, this does not prevent her from recovering the full measure of her damages. *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568, 572 (9th Cir. 1964).

**PLAINTIFF'S CLAIMS WERE NOT BARRED BY THE
STATUTE OF LIMITATIONS**

(H.U. Brief, 65-66)

The statute of limitations here applicable to plaintiff's claims under both the Federal Securities laws and the common law of California for breach of fiduciary duty is the California limitation for fraud actions. This limitation period is three years from the time of discovery. Calif. Code of Civil Procedure § 338(4).

Errion v. Connell, 236 F. 2d 447, 455 (9th Cir. 1956)

Fratt v. Robinson, 203 F. 2d 627, 634-635 (9th Cir. 1953)

Boyd v. Blankman, 29 Cal. 19, 44-47 (1865)

Agair Inc. v. Shaeffer, 232 Cal. App. 2d 513, 517 (1965)

A.

THE CHURNING OFFENSE CONTINUED UNTIL MARCH 1964

The statutory period does not commence to run until the "offense is completed" and when the offense is a continuing one, the period does not start until after the last tortious act. *Reynolds Metals Co. v. Yturbide*, 258 F. 2d 321, 332-333 (9th Cir. 1958), cert. denied, 358 U.S. 840 (1958); *Carroll v. United States*, 326 F. 2d 72, 86 (9th Cir. 1963).

As churning is determined by the overall activity in an account, and as the court found that the excessive activity continued up until the time of discovery in March 1964 it cannot be said that the statute began to run prior to that time.

B.

**WHERE THE PLAINTIFF HAS BEEN DEFRAUDED, THE STATUTE
DOES NOT RUN UNTIL ACTUAL DISCOVERY**

Because plaintiff was defrauded by defendants, the statute did not commence to run until at least March 1964.

Holmberg v. Armbrecht, 327 U.S. 392, 397 (1946):

"... where a plaintiff has been injured by fraud and 'remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not begin to run until the fraud is discovered, though there be no special circumstances or efforts on the part of the party committing the fraud to conceal it from the knowledge of the other party.'"

Only where the defrauded party should plainly have discovered the fraud except for his own inexcusable inattention will he be charged with discovery in advance of actual knowledge. *John Hancock Mut. L. Ins. Co. v. Markowitz*, 62 Cal.App. 2d 388, 412 (1944).

C.

DEFENDANTS FRAUDULENTLY CONCEALED PLAINTIFF'S CAUSE OF ACTION FROM HER

Fraudulent concealment of the cause of action, tolls the statute until actual discovery or, at least, substantially lessens the degree of diligence required of the plaintiff. *Azalea Meats, Inc. v. Muscat*, 386 F.2d 5, 9 (5th Cir. 1967); *Janigan v. Taylor*, 344 F.2d 781, 794 (1st Cir. 1965), cert. denied, 382 U.S. 879 (1965); *Tidewell v. Richman*, 127 F.Supp. 526, 533 (S.D. Calif. 1953).

The trial court found that Mr. Wilder did not explain "basic considerations" to plaintiff and showed her misleading summaries of the condition of her account which were beyond her comprehension and "were prepared in such manner as to allay any fear that the volume and frequency of the trading was excessive" and which "would have given the impression that no excessive trading was going on." 283 F.Supp. at 434. Mr. Wilder further limited plaintiff's ability to discover the true facts by his practice of picking up and retaining all the account papers sent to plaintiff (283 F.Supp. at 434) and further deceived plaintiff by his selective close-out scheme in commodities (See Opening Brief of Bertha Hecht, 26-32).

These facts demonstrate a fraudulent concealment from plaintiff so that the statute of limitations did not commence to run until at least March 1964 when she obtained some actual knowledge about the condition of her account.

D.

THE TRIAL COURT'S FINDING AS TO THE TIME OF DISCOVERY IS NOT CLEARLY ERRONEOUS

After weighing the evidence, the trial court concluded and found that plaintiff was not put on notice until March 1964 that the trading of her account was excessive and that discovery of the fraud did not occur until then. 283 F. Supp. at 441.

Defendants have not demonstrated, as they must, that this finding—which they apparently seek to challenge without calling it to the attention of this Court—is clearly erroneous. *Hobart v. Hobart Estate Co.*, 26 Cal. 2d 412, 439-441 (1945); *Sime v. Malouf*, 95 Cal. App. 2d 82, 104 (1949).

A plaintiff must discover all the essential facts constituting the fraud before the statute starts to run. *Berkey v. Halm*, 101 Cal. App. 2d 62, 69 (1950); *MacDonald v. Reich & Lievre, Inc.*, 100 Cal. App. 736, 741 (1929).

Mrs. Hecht was clearly unaware and lacked notice of all the essential facts regarding the churning and otherwise improper handling of her account until at least March 1964.

Until March 1964 plaintiff trusted and relied upon Mr. Wilder who had absolute control over her account (R.T. 1224, 2924, 2926, 3020, 3023-3024). In 1964 Mr. Sauer and Mr. Wood, who had prepared plaintiff's tax returns for seven years, reluctantly stepped out of their roles as tax accountants to ask her whether she understood what was happening to her account and whether she was receiving the Harris, Upham & Co. account papers (R.T. 1797-1799, 3072).

Mr. Sauer prepared a schedule showing gains and losses, interest charges and dividends received from 1956 through 1963 (Plaintiff's Exhibit 279) which he took with him in addition to plaintiff's 1963 tax return on a personal visit to plaintiff (R.T. 3062-3066, 3069).

Mr. Sauer pointed out the decline in net dividend income and the substantial losses which had occurred (R.T. 3072). Plaintiff was visibly shocked and upset at these revelations as she had not previously known the true condition of her account (R.T. 2434-2435, 2783, 3072-3074).

Plaintiff immediately phoned Mr. Wilder and told him to come to her house. When he arrived she was visibly excited and she told Mr. Wilder to leave her house and never return again (R.T. 2114-2118, 2436).

Upon the advice of the accountants and the investment advisor she was then taken to see—Mr. William P. Wentworth—directions were given to close out the commodities account and to transfer the securities from Harris, Upham & Co. (R.T. 1805). Plaintiff also directed that the black book ledger maintained by Mr. Wilder reflecting current securities transactions (Plaintiff's Exhibit 20A)—then in the possession of the accountants—was not to be returned to Mr. Wilder. He unsuccessfully attempted to get it back into his possession shortly after Mrs. Hecht ordered him out of her house (R.T. 2119-2120, 2436).

Thus, the record fully substantiates the finding that plaintiff's discovery of the excessive activity and the other improprieties did not occur until at least March 1964 and defendants' references to the record are merely attempts to reargue the evidence which was considered and rejected by the trial court.

Contrary to defendants' position (H.U. Brief, 66), the individual plaintiff is the standard rather than an abstract prudent man in determining what the plaintiff had reasonable notice of. Thus, if the plaintiff is old or is sick, a lesser standard of diligence applies. The standard here is what a woman of Mrs.

Hecht's physical and mental attributes reasonably would have know in these circumstances.⁴³

The standard defendants contend for would permit the infirm, the incompetent and the elderly to be taken advantage of with impunity and require customers of stockholders to assume they are dealing with rogues rather than skilled and professional fiduciaries. Such a requirement is obviously improper. *Laraway v. First Nat. Bk. of La Verne*, 39 Cal.App.2d 718, 728-730 (1940).

Further, when the parties are in a fiduciary relationship, the same degree of diligence in discovering fraud is not required because the plaintiff is under no duty to inquire and facts which would ordinarily require investigation may not excite suspicion. *Gross v. Needham*, 184 Cal. App. 2d 446, 455-456 (1960); *Bennett v. Hibernia Bank*, 47 Cal. 2d 540, 559-560 (1956); *Stevens v. Marco*, 147 Cal. App. 2d 357, 382 (1956); *Goodrich Co. (B.F.) v. Naples*, 121 F. Supp. 345, 348 (S.D. Calif. 1954).

So long as the fiduciary relationship continues unrepudiated, there is nothing to put the injured party on inquiry and only actual discovery will start the statute of limitations running. *Bennett v. Hibernia Bank*, 47 Cal. 2d 540, 561 (1956); *Lataillade v. Orena*, 91 Cal. 565, 578 (1891); *Cooney v. Glynn*, 157 Cal. 583, 589 (1910).

As the trial court properly found that defendants were in a fiduciary relationship to plaintiff (283 F. Supp. at 440), there can be no question that its finding as to the time of discovery should be sustained.⁴⁴

43. See *Azalea Meats, Inc. v. Muscat*, 386 F.2d 5, 10 (5th Cir. 1967) (emphasizing that the test of due diligence depends upon "the state of mind" of the plaintiff); *Acadia, California Ltd. v. Herbert*, 54 Cal.2d 328, 338 (1960) ("a tortfeasor must take his victim as he finds him").

44. The cases cited by defendants do not support the proposition that suspicion will start the statute running. To the contrary, hostility or even litigation does not necessarily break a fiduciary relationship and thereby start the statute running prior to the time of actual knowledge. *Stevens v. Marco*, 147 Cal. App. 2d 357, 376-377 (1956).

HARRIS, UPHAM & CO. WAS PROPERLY HELD LIABLE FOR THE ITEK AND COLONIAL TRANSACTIONS

(H.U. BRIEF, 26-28, 76-77, 90-91)

These two highly significant transactions indicating Mr. Wilder's misuse of his dominion and control over Mrs. Hecht are discussed in the Opening Brief of Bertha Hecht, 15-16.

It should first be noted that Harris, Upham & Co. does not deny the impropriety of Mr. Wilder's actions although it criticizes plaintiff for stating that these securities were "converted" and also denies that conversions are covered by the Federal Securities laws (H.U. Brief, 90). Certainly in end result Mrs. Hecht's Itek and Colonial shares were converted (283 F. Supp. at 442-443) and the conversion by stockbrokers of their customer's funds or securities has repeatedly been held to violate the Federal Securities laws.⁴⁵

A.

THE ITEK AND COLONIAL TRANSACTIONS WERE NOT BARRED BY THE STATUTE OF LIMITATIONS

1. PLAINTIFF'S PLEADINGS ENCOMPASSED THE TRANSACTIONS

The complaint alleged that defendants "engaged in acts, practices and a course of business which operated as a fraud and deceit upon plaintiff" (C.T. 3) and plaintiff set forth in as much detail as possible at that time and thereafter the specific acts constituting the fraud (C.T. 3-8, 92-93, 206, 211, 262-264).

Mr. Wilder first revealed during his deposition that he had purchased the Itek stock on the basis of a rumor, delivered it out to Mrs. Hecht upon discovering the illegality of the purchase, and thereafter "redeemed" them from Mrs. Hecht by paying her

45. *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440, 444-445 (N.D. Ill. 1967); *Cooper v. North Jersey Trust Co. of N.J.*, 226 F. Supp. 972, 978 (S.D.N.Y. 1964); *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966).

the purchase price of \$9,400 (Deposition of Asa V. Wilder, December 9, 1965, pp. 265-267).

Mr. George U. Harris—one of the two managing partners—demonstrated the awareness of Harris, Upham & Co.'s top management of the Itek transaction when he testified upon deposition in June 1966 that the firm "took the trade out of her account" as soon as the illegality was discovered and that if there was a profit "undoubtedly" Mrs. Hecht was asked about it (George U. Harris Deposition, 48).⁴⁶ Harris, Upham & Co. was charged with Mr. Wilder's knowledge of the transaction and had a duty to investigate. Reynolds & Co., 39 SEC 902, 911 (1960).

Thus, Harris, Upham & Co. itself raised the possibility that there was a profit on the Itek transaction and plaintiff expressly noted before trial that "Mr. Wilder has not yet disclosed the amount of any ultimate profit realized by him on this transaction" which transaction plaintiff alleged was "typical" of defendants' breaches of fiduciary duty (C.T. 420). Plaintiff also noted that the stock was at that time—prior to trial—selling for far more than the price Mr. Wilder paid Mrs. Hecht (C.T. 420; cf. R.T. 1461-1462).⁴⁷

Finally, Plaintiff's Trial Memorandum of Fact, which was filed six days prior to the commencement of the defendants' affirmative case, set forth the entire transaction in great detail including plaintiff's damages (C.T. 653-655).

The Colonial transaction was also encompassed within plaintiff's claim that defendants engaged in a fraudulent and deceitful course of business and practice. This transaction was not specifically set forth in plaintiff's pre-trial statements because plaintiff's counsel only pieced the facts together during the trial after

46. Admitted in evidence, R.T. 3636-3640.

47. Mr. Wilder destroyed part of the records relating to the transaction (R.T. 1467) while withholding and concealing other records and facts from plaintiff (C.T. 654-658).

Mrs. Hecht "suddenly remembered" what little she knew about the transaction (R.T. 3586-3591). She did not know that she had signed papers transferring the securities to Mr. Wilder without payment from him (R.T. 3588-3589).⁴⁸

Defendants are also charged with Mr. Wilder's knowledge of this transaction and thus cannot assert a lack of notice regarding it. Mr. Wilder's attorney, who worked closely with Harris, Upham & Co.'s counsel throughout the litigation, admitted he knew of the Colonial transaction "long before" it was brought out at the trial (Defendant Wilder's Memorandum After Trial, p. 4) and defendants had a full week after the exposure of the Colonial fraud on June 5, 1967 before they opened their defense.⁴⁹

A plaintiff is entitled to recover on his claims "on the basis of the facts as to damages shown in the record" and is not restricted to the allegations of damages pleaded.

Nester v. Western Union Telegraph Co., 25 F. Supp. 478, 481 (S.D. Calif. 1938)

Troutman v. Modlin, 353 F. 2d 382, 385 (8th Cir. 1965)

Societe Comptoir De L'Indus v. Alexander's Dept. Stores, 190 F. Supp. 594, 600 (S.D.N.Y. 1961), aff'd 299 F. 2d 33 (2d Cir. 1962)

Damages do not constitute the cause of action and the Itek and Colonial transactions were simply elements of the fraudulent course of conduct alleged by plaintiff and but one aspect of the damages she sustained.

48. As plaintiff cannot be charged with discovery of the Colonial transaction until her attorneys learned of it in June 1967, the statute of limitations did not begin to run until that time.

49. On June 6, 1967 defendants' counsel promised the court Harris, Upham & Co. would "insist on knowing what happened" and would "investigate" (R.T. 3756-3757). Their investigation apparently confirmed plaintiff's view of the transaction as they at no time attempted to refute it.

2. THE GRANTING OF PLAINTIFF'S MOTION TO CONFORM THE PLEADINGS TO THE PROOF RESULTED IN A RELATION BACK OF THESE TRANSACTIONS TO THE TIME THE COMPLAINT WAS FILED

Defendants fail to bring to the attention of this Court the fact that the trial court granted plaintiff's motion to conform the pleadings to the proof regarding the Itek and Colonial transactions (R.T. 4745, 4748-4749).⁵⁰

Under Rule 15(c) of the Federal Rules of Civil Procedure, the effect of this order was to relate the Itek and Colonial issues back to the time of filing of the complaint regardless of whether they were encompassed by the pleadings. Under the rule, relation back occurs whenever the new issue "arose out of the conduct, transaction or occurrence set forth" in the original pleading.

This rule is to be applied whenever "there is an identity between the amendment and the original complaint with regard to the general wrong suffered and with regard to the general conduct causing such wrong" (*United States v. Templeton*, 199 F. Supp. 179, 183 (E.D. Tenn. 1961)) and applies even though the new matter was unknown to the plaintiff when he filed suit if it merely amplifies and gives greater specificity to the original cause of action or states new grounds germane to the original charges. *Bowles v. Pure Oil Co.*, 9 Fed. Rules Serv. 15c.1, Case 2 (E.D. Pa. 1946). See also, *Wall v. Chesapeake & Ohio Ry.*, 339 F. 2d 434 (4th Cir. 1964).

Rule 15(c) is to be liberally applied, especially, as here, when there is no disadvantage to the opposing party. *Rural Fire Protection Co. v. Hepp*, 366 F. 2d 355, 362 (9th Cir. 1966). Motions to conform the pleadings to the evidence may be granted after the trial and even after judgment. *FDIC v. Siraco*, 174 F. 2d 360, 363 (2d Cir. 1949); *Blackwell v. Regal Cab Co.*, 316 F. 2d 398 (D.C. Cir. 1963); *Atchison, T. & S. F. Ry. Co. v. Judson Forwarding Co.*, 49 F. Supp. 789, 795 (S.D. Calif. 1943), aff'd 150 F. 2d 210 (9th Cir. 1945).

50. Harris, Upham & Co. also moved to conform the pleadings to the proof (R.T. 4395).

It is only in extraordinary situations and when the opposing party will be so prejudiced that even a continuance will not cure it that a motion to conform the pleadings to the evidence will be denied. 3 Moore's *Federal Practice*, pp. 984-986, 1011-1012.

Defendants were not prejudiced by the granting of the motion to conform and were given every opportunity to and did present whatever evidence they desired on these issues (*infra*, 79-82). The trial court's ruling was, therefore, proper. As a result, even assuming the Itek and Colonial issues were not encompassed by plaintiff's original claims and cause of action, they related back to the time the complaint was filed as these issues were merely specifications of the general wrong and conduct complained of.

B.

THE COLONIAL SHARES WERE NOT A GIFT FROM MRS. HECHT

Defendants repeatedly ignore (H.U. Brief, 27, 76) that Mrs. Hecht denied that the Colonial shares were a gift and that the trial court agreed, finding that Mr. Wilder had obtained them by fraud. 283 F. Supp. at 442.

C.

DEFENDANTS WERE GIVEN EVERY OPPORTUNITY TO CROSS-EXAMINE AND TO PRESENT EVIDENCE ON THESE TRANSACTIONS

Without setting forth the facts, Harris, Upham & Co. contends it was not given the opportunity to cross-examine plaintiff or to tender evidence on these two transactions (H.U. Brief, 76). The record bespeaks the contrary.

First, the trial court did not exclude the evidence regarding these transactions as to Harris, Upham & Co. but rather received it subject to objection and reserved ruling as to whether and for what purpose it would be admitted against Harris, Upham & Co. (R.T. 2314-2315). Defendants were not precluded from cross-examining but rather voluntarily chose not to do so. By

making this choice and by failing to obtain a definite ruling on the admission of the evidence, Harris, Upham & Co. waived whatever rights it might have had to complain.⁵¹

Further, when there is no jury the trial judge may admit any evidence offered and reserve decision on what legal effect to give it until he decides the case. *McComb v. McCormack*, 159 F. 2d 219, 227 (5th Cir. 1947).

Harris, Upham & Co. made a further waiver of any objections by accepting the procedure the trial court indicated it would follow—and thereafter did—regarding the evidence on these two transactions.

At the further hearing of October 20, 1967 ordered by the trial court, Harris, Upham & Co.'s counsel claimed the evidence regarding Itek and Colonial had been excluded as to his client but was incapable of making an offer of proof on these issues stating he would have to "investigate" (R.T. 4709) even though on June 6, 1967 he had solemnly informed the court that Harris, Upham & Co. was very concerned about these transactions and would "investigate" them (R.T. 3756-3757).

Acting so that there could not be the slightest question of surprise or prejudice, the trial court agreed with defendants' counsel that "if your Honor were going to include that testimony this record has to be opened up to permit me to expound" (R.T. 4706) and stated that if he were to change his ruling, he would "set aside" the submission and give defendants "an opportunity to either investigate and/or introduce evidence if you intended to introduce evidence" (R.T. 4712).

The trial court's preliminary Memorandum of Decision of January 19, 1968 found that the Itek and Colonial transactions were frauds upon Mrs. Hecht for which both Mr. Wilder and Harris, and Upham & Co. were liable but it specifically stated that these

51. *Goodale v. Thorn*, 199 Cal. 307, 315 (1926); *Fibreboard Paper Prod. Corp. v. East Bay Union*, 227 Cal. App. 2d 675, 698 (1964).

findings were "*subject to the right of defendants, if so advised, to reopen the case for presentation of further evidence and further trial upon the Itek and Colonial issues*" (C.T. 947-950) (emphasis added).

On February 7, 1968 Harris, Upham & Co. filed a "Notice of Intent to Reopen Case" for the purpose of the "presentation of further evidence and further trial upon the Itek and Colonial issues."

On March 4, 1968 the trial court reopened the case for further trial on Itek and Colonial and both set aside its findings with respect thereto (R.T. 4734-4735) and explicitly admitted the prior evidence against Harris, Upham & Co. (R.T. 4741-4742). *Defendants tendered in evidence one document which was admitted and then rested* (R.T. 4736-4741).⁵²

When defendants presented their additional evidence on Itek and Colonial no findings existed as they had been set aside. The trial court found Harris, Upham & Co. liable for these transactions on March 22, 1968, when an order modifying its earlier decision was filed. This order found the Itek and Colonial facts as originally set forth in the Memorandum of Decision after first noting that these earlier findings "were set aside and full opportunity was granted to defendant for further trial" (C.T. 995).⁵³

By accepting and participating in the procedure utilized by the trial court and by reopening the case and presenting further evidence, defendants again waived any rights they might have had

52. Plaintiff was present for cross-examination but defendants did not call her to the stand (R.T. 4744). Mr. Wilder had been subpoenaed by plaintiff but failed to appear.

53. It rests within the sound discretion of the trial court to reopen the case even after judgment to admit evidence in support of the judgment. *Hernberg v. Tipton*, 133 F. 2d 67, 69 (7th Cir. 1943); 88 C.J.S., *Trial* § 104 et. seq. Here the case was reopened at the request of defendants.

regarding these transactions.⁵⁴ They were provided more than sufficient time to investigate and to present their evidence and have no grounds for complaint. A party may not charge error which he himself induced the court to commit, or in which he has acquiesced or consented. *Walker v. Marshall*, 111 F.2d 794, 795 (9th Cir. 1940); *Harris v. Jackson*, 30 F. Supp. 185, 187 (E.D. Okla. 1939).

In any event, no error was committed which substantially affected justice in this case. Rule 61, Federal Rules of Civil Procedure.

D.

THE TRIAL COURT PROPERLY HELD DEFENDANTS LIABLE FOR A LACK OF SUPERVISION REGARDING THESE TRANSACTIONS

The trial court's finding that Harris, Upham & Co. was liable for these transactions because of its inadequate supervision (283 F. Supp. at 443) has not been shown by defendants to be clearly erroneous.

The evidence demonstrating defendants' failure to supervise has been discussed elsewhere (*supra*, pp. 54-57). In this regard it should also be noted that the Itek stock was originally purchased through Harris, Upham & Co. upon Mr. Wilder's solicitation. The order department called his attention to the illegality of the purchase and told him it couldn't be retained in the account (R.T. 1455, 3460, 3466). Mr. George U. Harris stated that the proper procedure was for the firm to take the transaction out of Mrs. Hecht's account, which he thought had been done in a "perfectly proper and ethical" manner (George U. Harris Deposition, 48). No one at Harris, Upham & Co. ever followed through to see what "perfectly proper and ethical" steps Mr. Wilder took regarding the stock nor did it ask him why this stock was being

54. On March 4, 1968 the trial court made it quite clear to defendants that if they introduced additional evidence this would waive their claims of prejudice and pre-judgment by the Court (R.T. 4735-4537). Defendants thus acted with full knowledge of the consequences.

delivered out even though it was the only stock delivered out of plaintiff's account in seven years (R.T. 1454-1455, 3460, 3463).

Mr. Wilder sold Mrs. Hecht's Itek through his wife's account at Harris, Upham & Co. (R.T. 3503, 3523) and the Colonial shares were apparently also sold through Harris, Upham & Co. (R.T. 3517-3518, 3524-3525; Plaintiff's Exhibits 310, 311, 314). Although some of these securities may have been transmitted through an account Mr. Wilder maintained at the Bank of California, Harris, Upham & Co. would know Mr. Wilder was selling them "because the stock certificate would come through with [his] name on it" (R.T. 3506). The maintenance of this account was improper under the rules of the New York Stock Exchange and Harris, Upham & Co.'s failure to question Mr. Wilder after it received the Colonial and other stock certificates in his name is a further indication of the firm's failure to supervise (R.T. 3606-3607).

Although the firm's general failure to supervise Mr. Wilder and his handling of Mrs. Hecht's account (*supra*, pp. 54-57) is sufficient basis for holding Harris, Upham & Co. liable on these two transactions, the additional evidence set forth above abundantly confirms the trial court's finding that defendants failed to adequately supervise Mr. Wilder regarding these two transactions.

Defendants also question whether these transactions involved the use of an interstate instrumentality. The Itek shares were purchased in the over-the-counter market and both the Itek and Colonial shares were sold through Harris, Upham & Co. These purchases and sales presumably involved instrumentalities of interstate commerce. Further, the mails were used to deliver the Itek out of the account to Mrs. Hecht and also to deliver Itek warrants directly to her home (R.T. 1454, 3520). Harris, Upham & Co.'s monthly statements on which the Itek purchase and delivery out were shown were mailed to plaintiff from New York. Mr. Wilder directly received Itek stock rights through the mails (R.T. 3466-3467).

Mr. Wilder first learned of the availability of the Colonial shares by a telephone call (R.T. 3483)—an instrumentality of interstate commerce—and the initial purchase of these securities was effected through the mails (R.T. 3485). The Colonial stock certificates and the transfer form directing the company to transfer the shares to Mr. Wilder were also sent through the mails (R.T. 3487, 3518-3519, 3529).

The use of the mails and of other instrumentalities of interstate commerce in connection with these fraudulent transactions is thus clear so that jurisdiction was properly found to lie under Rule 10b-5.

In any event, these transactions were only particular specifications of defendants' overall fraudulent conduct and as jurisdiction attaches to the overall scheme, it is not necessary that each individual wrongful act involve the jurisdictional means. *Fratt v. Robinson*, 203 F.2d 627, 633-634 (9th Cir. 1953); *Errion v. Connell*, 236 F.2d 447, 453 (9th Cir. 1956).

E.

HARRIS, UPHAM & CO. IS ALSO LIABLE BECAUSE MR. WILDER ACTED WITHIN THE SCOPE OF HIS EMPLOYMENT

As defendants note (H.U. Brief, 28), the trial court also held Harris, Upham & Co. liable for Mr. Wilder's conduct regarding the Itek and Colonial transactions because "Wilder was acting in the course of his employment for Harris, Upham" and "his conduct in such transactions must be deemed to be the conduct of Harris, Upham." 283, F.Supp. at 443.

A finding that an employee had ostensible authority and was acting within the scope of his employment is a factual finding which defendants must show to be clearly erroneous. *Ghiglione v. American Trust Co.*, 49 Cal.App.2d 633, 637 (1942); *Kamen & Co. v. Paul H. Aschkaer & Co.*, 382 F.2d 689, 694 (9th Cir. 1967).

Defendants admit that Mr. Wilder was Harris, Upham & Co.'s agent and acting within the scope of his employment in handling

plaintiff's securities account (R.T. 516-517; Plaintiff's Exhibit 192-1, p. 66). This admission encompasses the fraudulent manner in which Mr. Wilder removed the Itek stock from plaintiff's account after the firm informed him that it could not be returned as well as the Colonial transaction.

Ostensible authority was properly applied by the trial court to these two transactions. See Plaintiff's Memorandum After Trial of Law and Fact on Damages (C.T. 805-812).

In *Walsh v. Hooker & Fay*, 212 Cal.App.2d 450 (1963) the stockbroker contended that its registered representative acted without the scope of his authority in recommending and inducing plaintiff to purchase a particular security by means of false representations. The firm was unaware that the registered representative had purchased the stock for the customer outside the firm although it was eventually delivered into the plaintiff's account.

In finding the firm liable the court notes that the registered representative's job included making recommendations to customers to buy and sell securities and executing their orders, which services he fraudulently performed in this instance.

"The theory of ostensible agency is that the agent's position facilitates the consummation of the fraud, in that from the point of view of the third person, the transaction seems regular on its face and the agent appears to be acting in the ordinary course of the business confided to him." 212 Cal. App. 2d at 456.

In *Blackburn v. Dean Witter & Co.*, 201 Cal. App. 2d 518 (1962), the registered representative induced the elderly and widowed plaintiff to invest in a non-existent company, misappropriating her funds to himself. He gave her commercial "rediform" receipts which he later supplemented by promissory notes. At no time did the transactions appear on the monthly statements sent to the plaintiff by the firm.

The court notes that ostensible authority applies even if the agent acts solely for his own purposes, and emphasizes that

broker-dealers know that "this is a highly specialized and technical business" in which "customers rely on their employees for advice, guidance and consultation." The court also holds that the firm cannot accept the benefits of the transaction—the commissions on the sale of stock the proceeds of which were misappropriated—while denying "liability for the fraudulent misuse of the money obtained by the sale of the stock." 201 Cal. App. 2d at 521-522.

The Itek and Colonial facts come within the rule of these cases.

Mr. Wilder was employed by Harris, Upham & Co. to recommend to and effect for customers the purchase and sale of securities. Mrs. Hecht's relationship to Mr. Wilder existed solely because of his employment by Harris, Upham & Co. and all of his acts—including the Itek and Colonial transactions—occurred because Mr. Wilder was her stockbroker and financial advisor.

The Itek and the Colonial transactions were to Mrs. Hecht simply two more recommendations from Mr. Wilder relating to the purchase and sale of securities. He arranged for and took care of these transactions as he did with all the others and she, always compliant, signed whatever papers he placed in front of her. Mr. Wilder listed the Colonial transaction on the capital gains schedule he prepared for all of plaintiff's transactions. That Mrs. Hecht did not receive any proceeds from the "sale" was consistent with the usual operation of her account whereby all the proceeds of sale were returned in the account.

Harris, Upham & Co. facilitated the consummation of these frauds by clothing Mr. Wilder with the apparent authority to assist and advise people regarding all their securities investments.⁵⁵

55. Harris, Upham & Co.'s advertising stressed its experience in investment matters and its ability to plan an investment program particularly suited to the individual's needs (C.T. 596-599). Even assuming Harris, Upham & Co. was innocent, it should suffer the loss rather than Mrs. Hecht because it was "responsible for the selection of the agent and for the definition of his authority." *Warschauer v. Bauer Construction Co.*, 179 Cal.App.2d 44, 50 (1960).

It must, therefore, bear the consequences of its employee's misuse of that authority.

Moreover, and contrary to its claim (H.U. Brief, 77), Harris, Upham & Co. did benefit from these transactions. The Itek stock was purchased and sold through Harris, Upham & Co. while the Colonial stock was sold through the firm so that commissions or mark-ups were received on these transactions. Further, the \$15,000 Mrs. Hecht paid for the Colonial stock was raised from the sale of securities in her account on which commissions were charged (Monthly Statement for 9-25-59, Plaintiff's Exhibit 21E). *Harris, Upham & Co. cannot "accept the benefits of the sale of the stock by [Wilder] as their agent and deny liability for the fraudulent misuse of the money obtained by the sale of the stock". Blackburn v. Dean Witter & Co.*, 201 Cal.App.2d 518, 522 (1962) (emphasis added). See also, *Reusche v. California Pac. Title Ins. Co.*, 231 Cal.App.2d 731, 737 (1965).⁵⁶

It is of no importance that the employee's act is contrary to the employer's rules and regulations or in violation of express instructions. *Adams v. American President Lines*, 23 Cal.2d 681, 687-688 (1944); *Sullivan v. People's Ice Corp.*, 92 Cal.App. 740, 744 (1928); *De Mirjian v. Ideal Heating Corp.*, 129 Cal.App.2d 758, 766 (1954).

Customers of broker-dealers expect and are entitled to receive "proper treatment and to be protected against fraud and other misconduct" and "may properly rely on the firm to provide this protection." *Reynolds & Co.*, 39 SEC 902, 917 (1960). When employees or agents convert a customer's securities or funds, the broker is responsible.

56. It is not, however, important whether the principal benefits from the fraudulent transaction. *Walsh v. Hooker & Fay*, 212 Cal.App.2d 450, 456 (1963); *Transport Clearings—Bay Area v. Simmonds*, 226 Cal.App. 2d 405, 427 (1964).

Goodman v. H. Hentz & Co., 265 F.Supp. 440, 444-445 (N.D. Ill. 1967) (selling non-existent securities to customers and converting the funds)

Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 253 F.Supp. 359, 367 (S.D.N.Y. 1967) (a violation of Section 10(b) and Rule 10b-5 occurs when there is a conversion of a customer's funds)

Cooper v. North Jersey Trust Co. of N.J., 226 F.Supp. 972, 978 (S.D.N.Y. 1964)

Calvert Securities Corp., 35 SEC 141 (1953)

W. F. Coley & Co., 31 SEC 722 (1950)

Ira S. Bushey & Sons, Inc. v. United States, 398 F.2d 167, 170-172 (2d Cir. 1968)—cited by defendants—phrases the test of the limits of the doctrine of respondeat superior in terms of whether the type of harm committed is reasonably foreseeable. Certainly it is foreseeable that registered representatives will cheat and defraud customers in the manner in which plaintiff was defrauded by Mr. Wilder.⁵⁷ For discussion demonstrating that respondeat superior is an independent basis of liability under the Federal Securities laws, see *supra*, pp. 58-60.

F.

THE TRIAL COURT ALSO HAD PENDENT JURISDICTION TO AWARD DAMAGES FOR THESE TRANSACTIONS

As the trial court had pendent jurisdiction to hear plaintiff's claim of breach of fiduciary duty under the law of California (*supra*, pp. 36-37), the trial court's assumption of jurisdiction over the Itek and Colonial transactions is sustainable on this ground independently of jurisdiction under the Federal Securities laws. The trial court's findings that Mr. Wilder failed to disclose all the relevant facts to plaintiff regarding these transactions (283

57. The other case cited by defendants, *Kamen & Co. v. Paul H. Aschkar & Co.*, 382 F.2d 689 (9th Cir. 1967), differs greatly from the present case in that the person asserting the ostensible authority of the employee was highly sophisticated and the trial court found that the employer had no reasonable grounds to believe that improper activities were taking place.

F.Supp. at 442-443) brings them squarely within the scope of the California cases imposing liability when the fiduciary fails to fully and fairly disclose all material facts. See cases and discussion at C.T. 559-561.

VIII

PLAINTIFF SUSTAINED SUBSTANTIAL DAMAGES FOR WHICH SHE WAS NOT FULLY COMPENSATED

Defendants' wrongful actions resulted in substantial injury to plaintiff—as the trial court found. The trial court, however, expressly declined to award plaintiff her "loss of bargain" because of its holding regarding estoppel and waiver. 283 F.Supp. at 440.

Plaintiff, as is the victim of any wrong, is entitled to be fully compensated for all of the damages she sustained. See Opening Brief of Bertha Hecht, 45-55.

A.

WAIVER AND ESTOPPEL CANNOT BE APPLIED TO RESTRICT PLAINTIFF'S DAMAGES

Plaintiff has previously set forth her position that estoppel and waiver were here improperly applied—both as a matter of law and on the facts. See *supra*, pp. 60-69. Should this Court agree with plaintiff's position, plaintiff would be entitled under the reasoning of the trial court to recover for all her damages resulting from defendants' failure to properly manage her account on an investment basis. 283 F.Supp. at 440.⁵⁸

B.

PLAINTIFF IS ENTITLED TO RECOVER DAMAGES BASED UPON HER LOSS OF BARGAIN

Defendants committed a serious fraud upon plaintiff causing her substantial and continuing harm. The victim of any tort is

58. As the trial court found (283 F.Supp. at 425) that plaintiff's original portfolio would have been worth \$776,000 more than it actually was on March 31, 1964 and that she would have received at least \$70,000 more in net dividend income on that portfolio than she in fact did, plaintiff contends that her damages should be calculated from these figures, subject to a capital adjustment of no more than \$9,000, plus compensation for the Itek and Colonial securities. See Opening Brief of Bertha Hecht, 48-50.

entitled to recover for *all* resulting detriment, whether it could have been anticipated or not (Calif. Civil Code § 3333), and a more liberal measure of damages applies in tort—as contrasted to contract—actions. *Fire Assoc. of Philadelphia v. Allis Chalmers Mfg. Co.*, 129 F.Supp. 335, 349 (N.D. Iowa 1955); 14 Cal.Jur.2d, *Damages* § 20; 22 Am.Jur.2d, *Damages*, § 18.

A broad measure of damages is here particularly appropriate for the trial court found that defendants breached their fiduciary duties to plaintiff (283 F.Supp. at 440) and in such circumstances the law is particularly concerned that the plaintiff recover for *all* losses caused by the unfaithful fiduciary. See Opening Brief of Bertha Hecht, 51-52.

Because of defendants' wrongful acts, plaintiff is entitled to recover her loss of bargain. *City of Salinas v. Souza & McCue Construction Co.*, 66 Cal. 2d 217, 225 (1967) (contractor entitled to recover his indirect overhead *and reasonable profit* on extra services and materials required because of misrepresentations as to site conditions); *Walsh v. Hooker & Fay*, 212 Cal.App.2d 450 (1963). See also, *Morris v. Harbor Boat Building Co.*, 112 Cal. App.2d 882, 889 (1952):

"The measure of damages in such a case [fraud] is the difference between what the buyer has actually received and that which, except for the fraud, he would have received and had the right to expect to receive" (emphasis added).

In *Esplin v. Hirschi*, 402 F.2d 94, 102 (10th Cir. 1968), where the defendant misrepresented the value of securities, the court held that the defrauded purchasers were entitled to recover the original purchase price *plus interest from the date of purchase* less any residual value left in the securities at the time the fraud was discovered.

Plaintiff is likewise entitled to have a return on her investment—represented in *Esplin* by the recovery of interest on the original investment—considered in the computation of damages. Award-

ing plaintiff the benefit of her bargain through inclusion of a return on her capital is not only reasonable but here it is the more "accurate method of damage measurement." *Hartwell Corporation v. Bumb*, 345 F.2d 453, 457 (9th Cir. 1965).

C.

PLAINTIFF'S LOSS OF BARGAIN WAS THAT SHE DID NOT RECEIVE THE BENEFITS OF A PROPERLY MANAGED ACCOUNT

The trial court notes that plaintiff's loss of bargain was that she did not receive the benefits of a properly managed investment account. 283 F.Supp at 440. This accords both with plaintiff's expectations that her account was to be handled on an investment basis and defendants' obligation to so treat it.

Defendants admit that plaintiff's account prior to being taken over by Harris, Upham & Co. was "dormant" and the trial court has found that her Walston account was a "relatively inactive investment type account." 283 F.Supp. at 429. *Defendants also admit that the account was managed as a trading account at Harris, Upham & Co. which management "was perhaps contrary to her needs and circumstances"* (H.U. Brief, 100).

Thus defendants have admittedly not acted—as they were required to—in the utmost good faith and fairness towards plaintiff and with her interests as their foremost concern. If defendants had met their obligation to suitably and properly manage this account, they would have handled it as an investment account and effected but few transactions and only ones designed to improve plaintiff's investment position. Instead, however, defendants breached their duty to plaintiff by disposing of her original investment quality portfolio and using the proceeds to repeatedly buy and sell speculative and non-dividend paying securities and commodities.

Defendants assert, however, that even though plaintiff did not receive her bargain—proper investment management—the resulting damages were not proximately caused by their conduct.

The question of proximate cause in essence means only "that there be some reasonable connection between the act or omission of the defendant and the damage which the plaintiff has suffered" (Prosser, *Torts* (3d Ed. 1964), p. 240), and ultimately reduces itself to the simple determination of "*who is responsible for what happens.*" *R. H. Johnson & Co. v. SEC*, 198 F.2d 690, 697, n. 17 (2d Cir. 1952), cert. denied, 344 U.S. 855 (1952) (emphasis added). See also, *Williams v. Krumsiek*, 109 Cal.App.2d 456, 459 (1952) (the test is whether the "benefits claimed were reasonably certain to have been realized but for the wrongful act").

Defendants are here clearly responsible for what happened because of Mr. Wilder's control over plaintiff and her account. If defendants had not sold Mrs. Hecht's original investment portfolio and thereafter operated her account as a trading account in securities and commodities, plaintiff would have retained her original investment portfolio—or one of equivalent investment quality—and in March 1964 held a portfolio worth far more than that portfolio with which she was left by defendants and a portfolio from which she would have earned far more in dividend income than she in fact received. But for defendants' acts, plaintiff would have received these benefits of proper investment management.

Defendants also assert that to award damages on the basis of the original portfolio would be arbitrary and would require the court to engage in speculation (H.U. Brief, 106, 108). This ignores that the rule of uncertainty applies to the fact of damage and not to the *amount or the extent of the damages sustained*. *Bigelow v. RKO Radio Pictures, Inc.*, 327 U.S. 251-266 (1946):

"'Difficulty of ascertainment is no longer confused with right of recovery' for a proven invasion of the plaintiff's rights." See also, *Universal Pictures Co. v. Harold Lloyd Corp.*, 162 F.2d 354, 368 (9th Cir. 1947).

The wrongdoer must bear the consequences of his wrongdoing and cannot complain solely because the computation of damages—which he has caused—may be difficult. *Bigelow v. RKO Radio*

Pictures, Inc., 327 U.S. 251, 264-265 (1946). Any reasonable means of computing the extent of damages is acceptable even though the result be only approximate. *Story Parchment Co. v. Paterson Parchment Paper Co.*, 282 U.S. 555, 561-568 (1931).

The fact of damage is here clear. What remains for this Court, it is submitted, is the determination of the proper legal measure of plaintiff's damages. Plaintiff contends that she is entitled to recover for all her damages, including the benefit of her bargain, and that she is entitled to those damages regardless of estoppel and waiver. Certainly, if estoppel and waiver cannot here be applied, plaintiff should recover the benefits of a properly managed investment account.

**D.
DEFENDANTS CANNOT COMPLAIN OF THE DAMAGES
ACTUALLY AWARDED**

The amount of damages awarded was considerably less than the amount to be awarded by the loss of the bargain measure already discussed. Further, even if plaintiff were restricted to those damages arising from the churning of her account, she was not compensated for the income taxes and transfer taxes she paid arising from that churning. See Opening Brief of Bertha Hecht, 52-54. Defendants have, therefore, no grounds for attacking the trial court's award of damages.

Defendants in the main merely reargue matters relating to liability and fail to recognize that the trial court need not even explain the basis of its computation of damages. Further, the amount of damages—as contrasted to the measure—is a question of fact which defendants must show to be clearly erroneous. *Universal Pictures Co. v. Harold Lloyd Corp.*, 162 F.2d 354, 368 (9th Cir. 1947); *United States Nat. Bank v. Fabri-Valve Co.*, 235 F.2d 565, 568 (9th Cir. 1956).

1. COMMISSIONS AND INTEREST PAID

Of the \$232,000 awarded by the trial court for commissions and interest, defendants only dispute that plaintiff paid the approximately \$14,000 which represents mark-ups on principal

over-the-counter transactions (H.U. Brief, 73). Principal over-the-counter transactions in the gross amount of \$510,334 were effected for plaintiff's account (Plaintiff's Exhibit 296). Harris, Upham & Co. marked-up such transactions to 3% and even more (R.T. 3210, 3212). As the amount awarded for mark-ups was less than 3% of the principal transactions, it is supported by substantial evidence.⁵⁹

Defendants contend that the securities or the commodities account were inactive in particular years (H.U. Brief, 75). This ignores that (1) churning is an offense concerned with the overall activity in the account, (2) the commodities and securities commissions are to be considered together, and (3) that the trial court has found that the overall activity was excessive.

The margin interest of \$43,000 paid by plaintiff was the direct result of the churning of her account in that by keeping the account fully margined, Mr. Wilder was able to buy (and thereafter sell) more securities than he otherwise would. As the trial court found, Mr. Wilder repeatedly inquired of the main office in New York to determine the available "buying power" in plaintiff's account for the apparent purpose of trading the account to the limit so as to generate commissions. 283 F.Supp. at 436.⁶⁰

2. REALIZED COMMODITY LOSSES

Defendants do not dispute that plaintiff's realized losses in commodities (over and above commissions paid) were \$78,000 as the trial court found. 283 F.Supp. at 440.

59. Moreover, as defendants failed to produce the exact figures on mark-ups they are in no position to complain as the trial court used the best means available to it to compute this element of damages.

60. In awarding all of the commissions and interest, the trial court properly utilized the well recognized legal principle that one who is the cause of the uncertainty in determining damages cannot complain if the upper limit is taken as the proper figure. Defendants failed to prove to what extent the commissions and interest were not excessive and therefore cannot attack the award of the entire amounts. *Gratz v. Cloughton*, 187 F.2d 46, 51-52 (2d Cir. 1951).

The causal connection between defendants' wrongful acts and these losses is clear in that all of the commodities transactions were excessive and unsuitable in view of plaintiff's investment needs and were effected solely for the purpose of generating commissions.

3. LOSS OF DIVIDEND INCOME

The trial court awarded \$65,000 for loss of dividend income because defendants "substantially" impaired the "income and income potential" of plaintiff's account by effecting transactions in commodities—which do not pay dividends—and by selling dividend-paying securities to acquire speculative, non-dividend paying securities. 283 F.Supp. at 440.

The figures relating to the decline in plaintiff's dividend income are striking (See Opening Brief of Bertha Hecht, 23), and the trial court found that the overall loss was *at least* \$65,000. The record reflects that had plaintiff's original portfolio been maintained, she would have received between \$70,000 and \$108,000 more in dividend income than she did in fact up to March 1964 (Plaintiff's Exhibits 280-282) without even considering plaintiff's continuing loss of income since that time. The \$65,000 award is, therefore, clearly supported by the evidence.

4. ITEK AND COLONIAL

Defendants make no challenge to the amount of damages awarded for these two fraudulent transactions.

5. INTEREST

The trial court properly held "that the equities of the situation are such that interest at the rate of seven per cent (7%) should be awarded", although it restricted its interest award to a portion of plaintiff's damages. 283 F.Supp. at 444. Interest is to be given in response to considerations of fairness. *Board of Commissioners v. United States*, 308 U.S. 343, 352 (1939); *Miller v. Robertson*, 266 U.S. 243, 257-258 (1924).

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United States, 184 F.2d 802, 822 (9th Cir. 1950) and is designed "to compensate plaintiff for the loss sustained as the result of delay in receiving the amount to which he is held to be entitled." *E. I. duPont de Nemours & Co., v. Lyles & Lang Const. Co.*, 219 F.2d 328, 341-342 (4th Cir. 1955).

The propriety of awarding pre-judgment interest in securities fraud cases has been repeatedly recognized. *Collier v. Granger*, 258 F.Supp. 717 (S.D.N.Y. 1966); *Ross v. Licht*, 263 F.Supp. 395, 411 (S.D.N.Y. 1967); 3 Loss, *Securities Regulation*, 1795 (2d ed. 1961); *Speed v. Transamerica Corporation*, 135 F.Supp. 176, 198 (D. Del 1955), modified and aff'd 235 F.2d 369 (3rd Cir. 1956) (rate of pre-judgment interest increased).

In the present case, plaintiff was awarded interest on the specific and liquidated amount of commissions and interest she paid to Harris, Upham & Co.—\$232,000. Since even before March 1964—when plaintiff discovered the fraud—defendants have had the *use* and *benefits* arising from their fraudulent misappropriation of commissions and interest from plaintiff and their conversion of her Itek and Colonial securities.⁶¹ For the same period of time, plaintiff has been deprived of the income and capital growth which she otherwise would have received through investing these amounts as well as the remainder of her damages.

Thus, while plaintiff has not yet been even partially compensated for her losses, defendants continue to benefit from their wrongdoing. An award of interest is, therefore, equitable and just and should be applied by this Court to the entire amount of plaintiff's compensatory damages. *Speed v. Transamerica Corporation*, 235 F.2d 369, 374 (3rd Cir. 1956).

61. In addition, defendants substantially benefited from being able to rehypothecate 70-90% of the market value of plaintiff's securities pursuant to a power contained in their form of margin agreement (Plaintiff's Exhibits 94-96).

**PLAINTIFF'S MOTION TO REOPEN THE CASE
ON THE ISSUE OF PUNITIVE DAMAGES**

Plaintiff has requested this Court to review the trial court's denial⁶² of her motion to reopen the case on the issue of punitive damages⁶³ pursuant to the procedure set forth in *Canadian Inger-ell-Rand Co. v. Peterson Products*, 350 F.2d 18, 27 (9th Cir. 1965).

Plaintiff's motion was made pursuant to Rule 60(b) of the Federal Rules of Civil Procedure (C.T. 2013) because of defendants' fraud in concealing information from her and because plaintiff only discovered in August 1968⁶⁴—contrary to a verified answer to an interrogatory given by defendants—that Harris, Upham & Co. had been previously disciplined by the NASD (C.T. 2013).⁶⁵

At approximately the same time plaintiff's counsel also learned of the existence of certain private wires between the San Francisco and New York offices of Harris, Upham & Co. which played significant part in Mr. Wilder's selective close-out scheme (C.T. 2084, 2088).

These were not the only attempts of defendants to tamper with evidence but were part of a deliberate pattern of harassment and concealment (C.T. 655-658).

62. The trial court's decision is printed as Appendix B to the Opening Brief of Bertha Hecht.

63. The appellate court may order a retrial on the limited issue of punitive damages. *Lampert v. Reynolds Metals Co.*, 372 F.2d 245 (9th Cir. 1967); *Templeton Feed and Grain v. Ralston Purina Co.*, 69 A.C. 477, 36, 72 Cal.Rptr. 344, 349 (1968).

64. This was revealed by the NASD Decision disciplining defendants. Opening Brief of Bertha Hecht, Appendix A. The two exhibits attached to that Decision which were inadvertently omitted from that Appendix are attached hereto as Appendix B.

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Harris, Upham & Co. falsely denied under oath that records or information existed as to commissions generated by Mr. Wilder prior to 1962 (R.T. 269-271; C.T. 626-627, 1123-1124, 1202). It also denied under oath that Mr. Wilder ever received any bonus whereas, in fact, he received two \$5,000 bonuses because of his generation of commissions from plaintiff's account (R.T. 1362-63, 1369-71, 1410-1412, 1497-98, 4044-46; C.T. 622-626; 283 F. Supp. at 436, 439).

Plaintiff contends she was entitled to have all relevant and material information before the trial court before it ruled on the issue of punitive damages and requests this Court to rule on her motion to reopen on the issue of punitive damages (C.T. 2010-2076, 2083-2088, 3005-3024).

F.

PUNITIVE DAMAGES CAN AND HERE SHOULD BE AWARDED

It would be appropriate to award plaintiff not only punitive damages but also reasonable attorney's fees as sanctions because of defendants' conduct. *Hillman v. Stults*, 263 A.C.A. 975, 1009-1018, 70 Cal.Rptr. 295, 315-320 (1968).

The trial court properly held that Section 28(a) of the Securities Exchange Act applied only to actions expressly authorized by the Act and not to actions, such as the present one, brought under an implied right of recovery. 283 F.Supp. at 445.

Moreover, it is apparent from the language and structure of Section 28(a) that its purpose is to prevent a double recovery rather than to prohibit punitive damages and this interpretation has been upheld in at least one instance. *Baumel v. Rosen*, CCH Fed. Sec. L. Rep., para. 92,245 (D. Md. 1968), p. 97,159.

Punitive damages are clearly available under the Savings Clause ^{CONTINUED} in Section 16 of the Securities Act of 1933 (15 U.S.C.A. § 77p), which Act was invoked by plaintiff.⁶⁶ *Globus v. Law Re-*

66. The trial court did not expressly rule either on plaintiff's fraud claim made under the Securities Act of 1933 (C.T. 7, 869, 889) or on her request for attorney's fees (e.g., C.T. 883, 968-969). Because this case was

search Service, Inc., 287 F. Supp. 188 (S.D.N.Y. 1968). *Nagel v. Prescott & Co.*, 36 F.R.D. 445 (N.D. Ohio 1964).

Defendants incorrectly contend that Section 17(a) of the Securities Act does not apply to a broker-dealer when he acts as an agent rather than as a principal (H.U. Brief, 115). Section 17(a) prohibits the use of fraudulent devices "in the offer or sale" of securities and Section 2(3) (15 U.S.C.A. 77b (3)) defines "offer" as including the "*solicitation of an offer to buy.*" As Mr. Wilder admittedly solicited—with two exceptions—all of the transactions in plaintiff's account, defendants' fraudulent activities come within the coverage of Section 17(a).

It has been specifically held that a stockbroker wilfully violates Section 17(a) of the Securities Act—as well as Rule 10b-5—by using a relationship of "trust and confidence" to "cause transactions which are excessive in number in view of the investment character" of the accounts. *Looper and Company*, 38 SEC 294, 300, (1958). See also, *Leonard v. Colton*, CCH Fed. Sec. L. Rep., para. 92,284 (E.D.N.Y. 1968); *Norris & Hirschberg, Inc. v. SEC*, 117 F.2d 228, 231 (D.C. Cir. 1949), affirming 21 SEC 865, 886-887 (1946) (holding that Section 17(a) was violated by a stockbroker who excessively traded accounts to which he owed "fiduciary duties").

Punitive damages, therefore, might here have been awarded and plaintiff is entitled to the opportunity to fully present all the evidence upon which a decision on the issue of punitive damages is to be made.

Further, although attorney's fees are not generally recoverable in the absence of statute or contract, they are recoverable where—as here—there is malice or fraud. *Fremont Oil Co. v. Marathon Oil Co.*, 192 N.E.2d 123 (Ct. Com. Pleas of Ohio 1963); *Westbund v. Bond*, 8 Alaska 527 (1937); *Cooper v. Weissblatt*, 277

long and hard fought and demanded thousands of hours of counsel's time and because defendants attempted to conceal evidence from her, plaintiff is deserving of an award of a reasonable attorney's fee. She cannot be made whole unless such an award is made.

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It would be appropriate to award plaintiff not only punitive damages but also reasonable attorney's fees as sanctions because of defendants' conduct. *Hillman v. Stults*, 263 A.C.A. 97, 1009-1018, 70 Cal.Rptr. 295, 315-320 (1968).

The trial court properly held that Section 28(a) of the Securities Exchange Act applied only to actions expressly authorized by the Act and not to actions, such as the present one, brought under an implied right of recovery. 283 F.Supp. at 445.

Moreover, it is apparent from the language and structure of Section 28(a) that its purpose is to prevent a double recovery rather than to prohibit punitive damages and this interpretation has been upheld in at least one instance. *Baumel v. Rosen*, CC Fed. Sec. L. Rep., para. 92,245 (D. Md. 1968), p. 97,159.

Punitive damages are clearly available under the Savings Clause ~~CONTAINED~~ in Section 16 of the Securities Act of 1933 (15 U.S.C. § 77p), which Act was invoked by plaintiff.⁶⁶ *Globus v. Law R*

66. The trial court did not expressly rule either on plaintiff's fraud claim made under the Securities Act of 1933 (C.T. 7, 869, 889) or on her request for attorney's fees (e.g., C.T. 883, 968-969). Because this case was

search Service, Inc., 287 F. Supp. 188 (S.D.N.Y. 1968). *Nagel v. Prescott & Co.*, 36 F.R.D. 445 (N.D. Ohio 1964).

Defendants incorrectly contend that Section 17(a) of the Securities Act does not apply to a broker-dealer when he acts as an agent rather than as a principal (H.U. Brief, 115). Section 17(a) prohibits the use of fraudulent devices "in the offer or sale" of securities and Section 2(3) (15 U.S.C.A. 77b (3)) defines "offer" as including the "*solicitation of an offer to buy.*" As Mr. Wilder admittedly solicited—with two exceptions—all of the transactions in plaintiff's account, defendants' fraudulent activities come within the coverage of Section 17(a).

It has been specifically held that a stockbroker wilfully violates Section 17(a) of the Securities Act—as well as Rule 10b-5—by using a relationship of "trust and confidence" to "cause transactions which are excessive in number in view of the investment character" of the accounts. *Looper and Company*, 38 SEC 294, 300, (1958). See also, *Leonard v. Colton*, CCH Fed. Sec. L. Rep., para. 92,284 (E.D.N.Y. 1968); *Norris & Hirschberg, Inc. v. SEC*, 117 F.2d 228, 231 (D.C. Cir. 1949), affirming 21 SEC 865, 886-887 (1946) (holding that Section 17(a) was violated by a stockbroker who excessively traded accounts to which he owed "fiduciary duties").

Punitive damages, therefore, might here have been awarded and plaintiff is entitled to the opportunity to fully present all the evidence upon which a decision on the issue of punitive damages is to be made.

Further, although attorney's fees are not generally recoverable in the absence of statute or contract, they are recoverable where—as here—there is malice or fraud. *Fremont Oil Co. v. Marathon Oil Co.*, 192 N.E.2d 123 (Ct. Com. Pleas of Ohio 1963); *Westbund v. Bond*, 8 Alaska 527 (1937); *Cooper v. Weissblatt*, 277

long and hard fought and demanded thousands of hours of counsel's time and because defendants attempted to conceal evidence from her, plaintiff is deserving of an award of a reasonable attorney's fee. She cannot be made whole unless such an award is made.

N.Y. Supp. 709, 717 (Sup.Ct. 1935); *Kemp v. Miller*, 186 S.E. 99 (Va. 1936).

CONCLUSION

Although the trial of this case was extended, the exhibits voluminous, the memoranda many, and the arguments of defendants without end, it is submitted that the task of this Court is relatively simple.

The Court should determine that jurisdiction exists under the Federal Securities laws and the common law of California over a claim alleging that a securities account and a commingled commodities account were fraudulently churned and that securities were converted. The Court should then affirm the trial court's findings that such churning and conversion in fact occurred; that Harris, Upham & Co. is liable for the improper management of plaintiff's account; and that the statute of limitations did not begin to run before March 1964. Plaintiff further requests the Court to hold (a) that estoppel and waiver cannot properly be applied against plaintiff in this case; (b) that plaintiff is entitled to be fully compensated for all her damages, including the damages caused by defendants' failure to properly manage her account on an investment basis; (c) that plaintiff is entitled to an award of pre-judgment interest at 7% from March 1964 to the date of judgment; (d) that plaintiff is entitled to receive her costs of appeal and to apply to the trial court for an award of reasonable counsel fees incurred in the prosecution of this action. The case should then be remanded to the District Court for the entry of a judgment in conformity with the opinion of the Court.

Dated at San Francisco, California, January 30, 1969.

Respectfully submitted,

DONALD F. X. FINN

LOWENTHAL & LOWENTHAL

By REED H. BEMENT

By MORRIS LOWENTHAL

Attorneys for Bertha Hecht

Appendix A

SAINT FRANCIS HOSPITAL CONSULTATION RECORD

Date: May 26, 1955

| | |
|----------------------|-------------------------------|
| Name | Mrs. Bertha Hecht |
| Room | 428 |
| Doctor | Drs. R. Kistler & G. Bentinck |
| Age & Sex | 64 years; female |

Request for Consultation Regarding Neuropsychiatric Status.

Long history of use of barbiturates. In past few days has been confused, disoriented, and tremulous.

Dr. G. Bentinck/LJW
Signature of attending physician

REPORT OF CONSULTANT

Findings Acutely ill elderly woman. Coarse irregular twitchings of all extremities. Markedly confused; dysarthric; apparently responding to hallucinations. No localizing neurological signs. Prominent palmomental sign on right.

Diagnosis Acute brain syndrome following "silent" cerebral infarction. Bromide intoxication to be ruled out.

Recommendations Supportive and symptomatic treatment.

/s/ Leon J. Whitsell
Leon J. Whitsell, M.D.

Main update

Recap

| | | | | 1 | 2 | 3 | 4 |
|----|--|--|--|---|------------|---|---|
| 1 | Cash Contributed | | | | 43201468 | | |
| 2 | Cash Withdrawn | | | | 58716637 | | |
| 3 | Net Cash Cont. | | | | (15515169) | | |
| 4 | | | | | | | |
| 5 | Securities Contributed (Proceeds) | | | | 56276810 | | |
| 6 | | | | | | | |
| 7 | Total Contributions | | | | 40761741 | | |
| 8 | | | | | | | |
| 9 | | | | | | | |
| 10 | Securities Held (Value 3/3/64) | | | | 44489163 | | |
| 11 | | | | | | | |
| 12 | Difference - Profit | | | | 8727422 | | |
| 13 | | | | | | | |
| 14 | | | | | | | |
| 15 | | | | | | | |
| 16 | Profit to Firm - this account | | | | 76468- | | |
| 17 | 1% of Salesman's total commission - all accounts | | | | 36.8 | | |
| 18 | | | | | | | |
| 19 | | | | | | | |

MRS. Bertha Hecht
1957-1964
Harris, Upham & Co.

PURCHASES & LIQUIDATIONS

| <u>PURCHASES</u> | Month | YEAR | | | | |
|--------------------------|-----------|------|------|------|------|------|
| | | 1957 | 1958 | 1959 | 1960 | 1961 |
| | January | | 9 | 7 | 6 | 6 |
| | February | | 3 | 7 | 13 | 8 |
| | March | | 2 | 3 | 6 | 9 |
| | April | | 7 | 5 | 19 | 7 |
| | May | 4 | 3 | 6 | 11 | 10 |
| | June | 6 | 18 | 5 | 19 | 7 |
| | July | 8 | 7 | 4 | 19 | 3 |
| | August | 3 | 10 | 6 | 23 | 13 |
| | September | 5 | 9 | 6 | 6 | 6 |
| | October | 1 | 6 | 8 | 13 | 17 |
| | November | 7 | 9 | 7 | 13 | 11 |
| | December | 20 | 7 | 3 | 1 | 11 |
| Total purchases per year | | 54 | 90 | 67 | 149 | 128 |

Purchase liquidations

(includes purchases liquidated previously - short sales)

| <u>Time Held</u> | | | | | | |
|--|--|------|------|------|------|------|
| 0-1 month | | 4 | 6 | 4 | 2 | 12 |
| 1-2 months | | 5 | 11 | 2 | 7 | 12 |
| 2-3 months | | 10 | 5 | 6 | 10 | 5 |
| 3-4 months | | 5 | 7 | 3 | 10 | 11 |
| 4-5 months | | 2 | 10 | 6 | 5 | 9 |
| 5-6 months | | 1 | 3 | 6 | 9 | 6 |
| Sub-total | | (27) | (42) | (27) | (43) | (55) |
| 6-7 months | | 2 | 12 | 3 | 24 | 7 |
| 7-8 months | | 2 | 3 | 4 | 16 | 6 |
| 8-9 months | | 2 | 5 | 10 | 11 | 3 |
| 9-10 months | | 6 | 10 | 4 | 10 | 4 |
| 10-11 months | | 0 | 4 | 1 | 7 | 2 |
| 11-12 months | | 0 | 0 | 1 | 4 | 2 |
| OVER 1 YEAR | | 10 | 10 | 12 | 31 | 10 |
| Total purchases per year liquidated (includes purchases made to cover short sales) | | 49 | 86 | 62 | 146 | 89 |

Special Situations

| | <u>Date Purchased</u> | <u>Shares</u> | <u>Stock</u> | <u>Time Held</u> | <u>Shares</u> |
|----|-----------------------|---------------|---------------------------|------------------|---------------|
| 1. | 12-24-57 | 500 | General Motors | 0-1 month | |
| 2. | 9-19-58 | 200 | Chrysler | 2-3 months | |
| 3. | 9-22-58 | 300 | Chrysler | 3-4 months | |
| 4. | 8-24-59 | 500 | Amer. Smelting & Refining | 4-5 months | |
| 5. | 12-7-59 | 500 | Douglas Aircraft | 6-7 months | |
| 6. | 4-28-61 | 1000 | Gen. Tel & Elect | 7-8 months | |
| 7. | 8-24-61 | 200 | General Railway Signal | over 1 year | |
| 8. | 2-6-64 | 400 | General Motors | 9-10 months | |
| | | | | 11-12 months | |
| | | | | 10-11 months | |
| | | | | 0-1 month | |
| | | | | 1-2 months | |



IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BAKER COMMODITIES, INC.,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR REVIEW OF THE DECISION OF THE
TAX COURT OF THE UNITED STATES

BRIEF FOR THE APPELLEE

MITCHELL ROGOVIN,
Assistant Attorney General.

LEE A. JACKSON,
JONATHAN S. SMITH,
LESTER B. SNYDER,
Attorneys,
Department of Justice,
Washington, D. C. 20530.

MAR 10 1969

FILED

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| Argument: | |
| <p>The Tax Court correctly determined that the taxpayer was not entitled to a stepped-up basis for assets acquired in liquidation of three of its subsidiary corporations (Old Baker, Kerman, and Veronica) under Section 334(b)(2) and (3), inasmuch as two of these corporations (Old Baker and Kerman) were not acquired by "purchase", but in a Section 351 exchange, and inasmuch as the third corporation (Veronica) was acquired from persons who were deemed related to the taxpayer pursuant to the constructive stock ownership rules of Section 318 -----</p> | 21 |
| <p>A. Introduction -----</p> | 21 |
| <p>B. The Tax Court was warranted in finding that the taxpayer acquired the stock of Old Baker and Kerman in a non-taxable exchange under Section 351, rather than by purchase as required by Section 334(b) -----</p> | 24 |
| <p>C. The Tax Court was warranted in finding that the fifteen-year promissory note, issued by the taxpayer in conjunction with its acquisition of stock in Old Baker and Kerman, constituted a "security" for purposes of Section 351 -----</p> | 32 |
| <p>D. The Tax Court properly determined that the taxpayer acquired the stock of Old Baker and Kerman in 1961, and the stock of Veronica in 1962, from persons who were deemed to be related to the taxpayer pursuant to the constructive stock ownership rules set forth in Section 318, thereby precluding taxpayer from a stepped-up basis for the assets received upon liquidation of these corporations pursuant to Section 334(b)(3)(C) -----</p> | 41 |

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FOR THE NINTH CIRCUIT

No. 23,019

BAKER COMMODITIES, INC.,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR REVIEW OF THE DECISION OF THE
TAX COURT OF THE UNITED STATES

BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUES PRESENTED

Whether the Tax Court was clearly erroneous in holding that the taxpayer corporation did not acquire its stock in certain wholly-owned subsidiary corporations by "purchase" (as defined in Section 334(b)(3) of the Internal Revenue Code of 1954), thereby precluding the taxpayer from stepping-up the basis of the assets acquired in liquidation of these subsidiaries pursuant to Section 334(b)(2) of the Code. Resolution of this general question raises the following subordinate issues:

1. Whether the Tax Court was warranted in finding that the taxpayer acquired the stock of two ^{of} its wholly-owned subsidiaries in a non-taxable "exchange" under Section 351 of the Code, rather than by way of an isolated "purchase" of this stock;

Treasury Regulations on Income Tax:

| | |
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1. Whether the Tax Court was warranted in finding that the taxpayer acquired the stock of two ^{of} its wholly-owned subsidiaries in a non-taxable "exchange" under Section 351 of the Code, rather than by way of an isolated "purchase" of this stock;

2. Whether the Tax Court was warranted in finding that a 15-year promissory note, issued by the taxpayer in conjunction with its acquisition of the stock of these two subsidiary corporations, constituted a "security" for purposes of Section 351;

3. Whether, in the alternative, the Tax Court properly determined that the taxpayer was ineligible for a stepped-up basis because it acquired all the stock of these two subsidiary corporation from persons deemed to be related to the taxpayer pursuant to the constructive ownership rules set forth in Section 318 of the Code, and that under Section 334(b)(3)(c) such an acquisition does not qualify for a stepped-up basis under Section 334(b)(2);

4. Whether the Tax Court properly determined that the taxpayer acquired all its stock in a third wholly-owned subsidiary from person deemed to be related to the taxpayer, with the same consequences as in 3, supra;

5. Whether, in applying the constructive ownership rules of Section 318, the Tax Court properly determined that a certain partnership (whose partners were also stockholders in taxpayer corporation) was in existence where it had ceased to be engaged in an active business, yet continued to collect monies owed to it, and was not legally or factually dissolved or terminated under state law.

STATEMENT OF THE CASE

This petition for review involves federal income taxes in the amount of \$291,237.69 for the taxable year ended June 30, 1962, and 1 \$137,732.54 for the taxable year ended June 30, 1963. (I-R. 162-163.)

17 I-R. references are to the Transcript of Record, Volume One, which includes the documents of record filed with the Clerk of the Tax Court and the Findings of Fact and Opinion of the court.

The Tax Court entered its decision on the issues involved herein
by the Commissioner on February 27, 1968 (I-R. 162-163), and the
taxpayer filed its petition for review of this decision on March 28,
1968 (I-R. 164).^{2/} Jurisdiction is conferred on this Court by
Section 7482 of the Internal Revenue Code of 1954.

The facts found by the Tax Court^{3/} were based upon a partial
recapitulation of facts with exhibits attached thereto (I-R. 62-78), the
testimony of several witnesses, and several exhibits received in
evidence during the course of the trial, and may be restated as
follows:

Taxpayer, Baker Commodities, Inc., is a California corporation
having its principal office in Los Angeles, California. It filed its
federal income tax returns for the years in question with the
District Director of Internal Revenue, Los Angeles, California.
(I-R. 89.)

The Tax Court proceedings in this case were consolidated with
three other related cases involving three individuals, Frank Jerome,
Arney Jerome, and Paul Jerome, and their respective spouses. The
Jeromes transferred their stock in four corporations to the taxpayer
corporation in return for a 15-year promissory note. The Jeromes
were also stockholders of taxpayer corporation. The Tax Court held
that the Jeromes were entitled to report the payments received on this
note as amounts received in "exchange" of a capital asset, thereby
producing capital gain treatment. The Commissioner has accepted the
Tax Court's determination on this point, and the cases involving the
three individuals are not part of this appeal. In addition, the Tax
Court's determination that the taxpayer corporation involved in this
case was entitled to deduct interest payments on this 15-year note is
also not part of this appeal.

The findings of fact and opinion of the Tax Court are officially
reported at 48 T.C. No. 39 (1967).

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3. Whether, in the alternative, the Tax Court properly determined that the taxpayer was ineligible for a stepped-up basis because it acquired all the stock of these two subsidiary corporations from persons deemed to be related to the taxpayer pursuant to the constructive ownership rules set forth in Section 318 of the Code, and that under Section 334(b)(3)(c) such an acquisition does not qualify for a stepped-up basis under Section 334(b)(2);

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^{2/} The Tax Court proceedings in this case were consolidated with three other related cases involving three individuals, Frank Jerome, Varney Jerome, and Paul Jerome, and their respective spouses. The Jeromes transferred their stock in four corporations to the taxpayer corporation in return for a 15-year promissory note. The Jeromes were also stockholders of taxpayer corporation. The Tax Court held that the Jeromes were entitled to report the payments received on this note as amounts received in "exchange" of a capital asset, thereby producing capital gain treatment. The Commissioner has accepted the Tax Court's determination on this point, and the cases involving the three individuals are not part of this appeal. In addition, the Tax Court's determination that the taxpayer corporation involved in this case was entitled to deduct interest payments on this 15-year note is also not part of this appeal.

^{3/} The findings of fact and opinion of the Tax Court are officially reported at 48 T.C. No. 39 (1967).

The present controversy involves a determination of the basis to be assigned to certain assets acquired by the taxpayer on liquidation of three of its wholly-owned subsidiary corporations, the stock in which corporations was acquired from a partnership known as Jerome Brothers in two separate transactions, one in 1961 and the other in 1962. Since the resolution of the issues presented depends upon an analysis of the circumstances and conditions surrounding the taxpayer's acquisition of the stock in these subsidiary corporations, the facts relating to each transaction will be presented separately.

Facts Relating to the 1961 Transaction

Frank, Paul, and Varney Jerome are brothers who have been equal business partners since 1929 under the name of Jerome Brothers. In its early years, the partnership engaged in the fertilizer business. After discontinuing its fertilizer operations in 1937, it entered the business of rendering animal meat by-products into animal feeding fats and inedible tallow. (I-R. 90-91.)

The partnership continually expanded its operations and by June 1961, it owned interests in four corporations which were engaged principally in the rendering and tallow business; and the partnership itself conducted rendering businesses under fictitious names in the New Mexico, Honolulu, and Los Angeles areas. The corporations were Baker Commodities, Inc. ("Old Baker"),^{4/} Phoenix Tallow Company

^{4/} Since the taxpayer involved in this case adopted the same name (Baker Commodities, Inc.) as one of the corporations formerly owned by the Jerome Brothers partnership, the designations "New Baker" and "Old Baker" have been adopted to distinguish the former from the latter.

1

("Phoenix"), Kerman Tallow Works ("Kerman"), and San Joaquin Packing Company ("San Joaquin"). The Jerome Brothers partnership owned 100% of the stock in Old Baker and Phoenix, and 50% of the stock in Kerman and San Joaquin. The remaining 50% of the stock in Kerman and San Joaquin was owned by R.S. Wilson Company ("Wilson Co."), a California corporation owned entirely by Robert S. Wilson, who had been doing business with the Jerome Brothers partnership since 1947. The partnership also owned certain pieces of real property which had been used in connection with the rendering business. (I-R. 91-93.)

In addition to their rendering and tallow activities, the Jerome brothers joined together in 1954 with Jack Keith in forming a general partnership called Keith Engineering Company, which partnership was still in existence as of the time of trial of this case. Keith was a 50% partner and the three Jeromes owned the other 50% equally. Keith was an engineer who, since 1947, had done considerable engineering work for the Jerome Brothers partnership, and after the formation of the Keith partnership with the Jeromes, the Keith partnership was closely associated with the business of Old Baker and other Jerome interests, including the development of much of the plant equipment and techniques which the Jeromes used in their rendering business. (I-R. 66, 93-94, 111-112.)

The Jeromes were also involved in two limited partnerships, American Extraction Company ("American") and Manchester Medical Hospital ("Manchester"). American was created in 1956 for the sole purpose of purchasing sewer skimmings in order to extract and market

rease contained therein. Manchester was created in 1958 for the sole purpose of constructing, owning and operating a convalescent hospital. Five of the limited partners in each of these partnerships were also key employees of the Jeromes in their rendering businesses, and Jack Keith and Robert S. Wilson (associates of the Jeromes in their ventures described above) were also limited partners in American.^{5/} (I-R. 93, 114-116.)

Beginning in the early 1950's, the three Jerome brothers began considering the problem of perpetuating their tallow and rendering business. They were concerned with the ownership and management of that business after their deaths, and inasmuch as the brothers had no relatives other than each other who were in the top management of the business, they determined to transfer it to a group composed of themselves and seven other men, six of whom were key employees of the partnership.^{6/} The seventh, Jack Keith, was a partner of the Jeromes in Keith Engineering Company and American Extraction Company. (I-R. 93, 116.)

/ The respective percentages of the American and Manchester partnerships owned by the Jeromes and the other partners are set forth in the Tax Court's findings of fact. (I-R. 114, 116.)

/ The six employees selected by the Jerome brothers to participate in the transfer of the partnership business, together with their period of association with the business, were the following: Stephen Frank Schultz, employed since 1950; Louis J. Frederick, employed since 1952; Walter Sanderson, employed since 1953; James M. Andreoli, employed since 1951; Laverne A. Nelson, employed since 1951; and J.E. Rickert, employed since 1958. The Stipulation of Facts indicates that these persons were also employed by Old Baker in the following capacities: Schultz-Vice-President and General Manager; Frederick-Vice-President in charge of sales; Sanderson-Plant Superintendent; Andreoli-Controller and Office Manager; Nelson-Accountant and Auditor; and Rickert-Vice-President in charge of Customer and Public Relations. (I-R. 65, 66, 93.)

In the late 1950's, the three Jerome brothers began informal discussions with the seven keymen as to the possibility of transferring to them a part ownership in the partnership's tallow and rendering business. After a period of negotiations and appraisals of the various assets to be transferred, in early 1961, all ten individuals agreed to a price of \$3,212,000 for the partnership assets in question. No part of the negotiated price was attributable to goodwill. In May, 1961, the parties and their accountant consulted with tax counsel for the purpose of having the contemplated transaction effectuated in the most beneficial manner from a tax point of view. (I-R. 94-98.)

It was then decided that the transaction should be carried out by utilizing a corporation. Accordingly, on May 2, 1961, the taxpayer corporation, which had been organized under the name of American Extraction Company in 1956, was reactivated and its name changed to Jerome Brothers. ^{1/} (In July, 1961, the taxpayer corporation's name was again changed from Jerome Brothers to Baker Commodities, Inc., hereinafter also referred to as "New Baker".) On or about June 23, 1961, each of the seven keymen and the three Jeromes made a capital contribution to the taxpayer corporation in the amount of \$500, for a total paid-in capital of \$5,000, and in return each of these 10 individuals acquired 5 shares or 10% of the issued and outstanding capital stock of taxpayer corporation. (I-R. 99-100.)

^{1/} The American Extraction Company and Jerome Brothers corporations were legal entities separate and distinct from the previously mentioned partnerships with the same names.

Three days later, on June 26, 1961, an "Agreement of Purchase and Sale" was entered into between the Jerome Brothers partnership, as "seller", the taxpayer (New Baker) as "buyer", and the individual stockholders of the corporation, under which the taxpayer acquired from the partnership 100% of the stock of Old Baker and Phoenix and 50% of the stock of Kerman and San Joaquin, together with two parcels of real estate owned by the partnership and used in its rendering business. The agreement provided for a purchase price of \$3,150,000 together with an assumption of indebtedness of the partnership in the amount of \$62,000, amounting to a total purchase price of \$3,212,000. The purchase price was evidenced by a 15-year promissory note in the principal amount of \$3,150,000, bearing interest at the level rate of \$80,000 per year, with principal payable in equal annual installments of \$200,000 over the 15-year period. (I-R. 100.)

Under the terms of the agreement, each of the 10 stockholders was required, at the time of closing, to pledge 4.6 of his 5 shares, or 92 percent thereof, with a pledgeholder for the purpose of securing the payment of the promissory note. The pledge agreement, executed by the 10 individual stockholders of taxpayer, was incorporated by reference into the agreement of purchase and sale and provided that although the pledged stock was to be transferred to a pledgeholder, the pledgors (stockholders) would retain their voting rights in taxpayer. (I-R. 100-101, 103.)

In addition, the agreement imposed the following restrictions on the corporation so long as any part of the promissory note remained unpaid (I-R. 101-102):

COVENANTS OF BUYER

* * * Buyer will not, without prior written consent of Seller:

A. Make any change in the compensation, direct or indirect, to any officers or Stockholders of Buyer;

B. Permit any form of distribution of its corporate assets including, but without limitation thereto, the payment of dividends in stock or in cash;

C. Make any sale, assignment, conveyance, mortgage, pledge, encumbrance or lien of any of its assets, or any part thereof, except in the usual and ordinary course of business;

D. Amend its Articles of Incorporation or issue any additional shares of stock of any class;

E. Create any new debt of Buyer in excess of \$500,000.00 except in the usual and ordinary course of business in connection with purchase money obligations and obligations under conditional sales contracts or other title retention agreements with respect to new equipment acquired by the Buyer for use in the ordinary and usual conduct of its business;

F. Make loans, advances or guarantees to any person, firm or corporation except by way of assumption of liabilities of any subsidiary of the Buyer in connection with the liquidation and dissolution thereof and except that the buyer may make loans or advances not exceeding at any time the aggregate amount of \$100,000.00 of which amount not more than \$25,000.00 in the aggregate shall constitute loans or advances to officers or employees of the Buyer;

G. Purchase or acquire stock or securities or assets or the business of any other person, firm or corporation except: (1) by liquidation and dissolution of a subsidiary; or (2) all or a portion of the assets and business of any person, firm or corporation engaged in a business similar to that of the Buyer provided that the purchase price paid for any such transaction of purchase or acquisition shall not exceed \$250,000.00;

H. Enter into any partnership arrangement;

I. Merge or consolidate with any other corporation.

The Buyer further covenants that Buyer will at all times carry multiple risk insurance and maintain public liability and property damage insurance satisfactory to the Seller and that it will maintain its corporate existence and all licenses and franchises necessary or desirable to the profitable conduct of Buyer's business.

Also on June 26, 1961, the taxpayer and its stockholders entered into an agreement of purchase and sale with the Wilson company pursuant to which taxpayer "purchased" from that company the remaining 50% of the corporate stock of Kerman and San Joaquin. The agreement provided for a total purchase price of \$250,500, to be evidenced by a promissory note in that amount with interest at the rate of 6 percent per annum on the unpaid balance. Principal and interest were payable in 30 semiannual installments of \$12,725.40 each. In all other respects this contract contained the same terms, provisions, and conditions as the agreement entered into on the same day between the Jerome Brothers partnership and the taxpayer, including a pledge agreement entered into by the 10

8/
stockholders of taxpayer in favor of the Wilson Company. Robert S. Wilson, sole owner of the Wilson Company, was aware that the price, terms, and conditions surrounding the transfer to taxpayer of his company's 50 percent interest in Kerman and San Joaquin were identical to those surrounding the transfer by the Jerome Brothers partnership to the taxpayer of the other 50 percent interest in these two corporations. (I-R. 105-106.)

By reason of the acquisition of 100% of the stock of Old Baker, Phoenix, Kerman, and San Joaquin, those corporations became wholly owned subsidiaries of taxpayer (New Baker). At all times after June 26, 1961, San Joaquin and Phoenix continued to be operated by taxpayer as wholly owned subsidiaries. However, within 5 days after June 26, 1961, taxpayer adopted resolutions to completely liquidate Old Baker and Kerman, and such liquidations were carried out and the assets of Old Baker and Kerman were distributed to taxpayer in cancellation of their stock. (I-R. 106-107.)

Shortly after the liquidation of Old Baker and Kerman, taxpayer's internal auditing staff and outside accountant allocated the purchase price of the stock to the various tangible assets acquired by taxpayer as the basis thereof. Within three months after the allocations were made, the taxpayer sold several items of equipment at a price which was \$108,228.57 less than their recently allocated basis. (I-R. 107-108.)

8/ The pledge agreement in favor of the Wilson Company provided that the stockholders as a group would deposit 4 shares of taxpayer corporation's stock with the pledgeholder. Since 46 of the 50 issued and outstanding shares of taxpayer were already pledged, the pledging of the remaining 4 shares left none of taxpayer's stock unpledged as of June 26, 1961. (I-R. 106.)

Each of the stockholders of taxpayer, with the exception of [redacted], was at all times from June 26, 1961, to the time of the trial an employee of taxpayer. At the time of trial Shultz was a vice-president and general manager of taxpayer; Frederick was employed as its vice-president in charge of sales; Andreoli was employed as its treasurer, controller, and office manager; Sanderson as plant superintendent; Nelson was secretary; and Rickert was vice-president in charge of customer relations. Each of these six employees held substantially the same positions as employees of Old [redacted]. However, these keymen, principally Andreoli, assumed more responsibility and more administrative control over the taxpayer than they had before. Varney Jerome was employed as general manager of Phoenix and was an employee of taxpayer; Paul Jerome was employed by taxpayer as general manager of its Albuquerque operations; and Frank Jerome was employed by taxpayer as its president. (I-R. 65, 108, 109)

At the time taxpayer acquired the tallow and rendering business from the Jerome Brothers partnership, there existed obligations owing from the partnership to the Bank of America. Inasmuch as taxpayer agreed to assume these partnership obligations, the bank, in order to protect itself, required the three Jerome brothers to subordinate taxpayer's 15-year promissory note to the bank loan and, in addition, to personally guarantee taxpayer's indebtedness to the bank. (I-R. 110.)

Upon audit of taxpayer's income tax returns for the fiscal years ended June 30, 1962 and June 30, 1963, the Commissioner disallowed a new basis to taxpayer under Section 334(b)(2)^{9/} for the assets acquired in the 1961 liquidation of Old Baker and Kerman, and determined that the basis of such assets was the same as in the hands of these subsidiary corporations. Such disallowance resulted in the following adjustments: (1) for the taxable years ended June 30, 1962, and 1963, taxpayer's depreciation deductions were reduced by the sums of \$391,557 and \$202,855, respectively; (2) for the year ended June 30, 1962, taxpayer's deduction of a loss in the amount of \$108,228.57 on the sale of certain assets was disallowed and it was determined instead that taxpayer realized a gain of \$31,820 on such sale; and (3) for the year ended June 30, 1962, taxpayer's opening inventory was reduced by the sum of \$104,190.76, thereby reducing its deduction for cost of goods sold by that amount. (I-R. 35, 40, 124.)

Taxpayer sought review on this issue by petition to the Tax Court of the United States. (I-R. 1-25.) On the basis of the stipulated facts, the testimony and exhibits in the case, the Tax Court, sustaining the deficiencies determined by the Commissioner on the issue herein involved, held that taxpayer was not entitled to use a stepped-up basis in computing depreciation, cost of goods sold, and loss on the sale of the assets acquired on liquidation of

^{9/} References to sections are to the Internal Revenue Code of 1954, unless otherwise indicated.

Each of the stockholders of taxpayer, with the exception of Smith, was at all times from June 26, 1961, to the time of the trial an employee of taxpayer. At the time of trial Shultz was a vice-president and general manager of taxpayer; Frederick was employed as its vice-president in charge of sales; Andreoli was employed as its treasurer, controller, and office manager; Sanderson as plant superintendent; Nelson was secretary; and Rickert was vice-president in charge of customer relations. Each of these six employees held substantially the same positions as employees of Oldaker. However, these keymen, principally Andreoli, assumed more responsibility and more administrative control over the taxpayer than they had before. Varney Jerome was employed as general manager of Phoenix and was an employee of taxpayer; Paul Jerome was employed by taxpayer as general manager of its Albuquerque operations; and Frank Jerome was employed by taxpayer as its president. (I-R. 65, 108,

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Upon audit of taxpayer's income tax returns for the fiscal years ended June 30, 1962 and June 30, 1963, the Commissioner disallowed a new basis to taxpayer under Section 334(b)(2)^{2/} for the assets acquired in the 1961 liquidation of Old Baker and Kerman, and determined that the basis of such assets was the same as in the hands of these subsidiary corporations. Such disallowance resulted in the following adjustments: (1) for the taxable years ended June 30, 1962, and 1963, taxpayer's depreciation deductions were reduced by the sums of \$391,557 and \$202,855, respectively; (2) for the year ended June 30, 1962, taxpayer's deduction of a loss in the amount of \$108,228.57 on the sale of certain assets was disallowed and it was determined instead that taxpayer realized a gain of \$31,820 on such sale; and (3) for the year ended June 30, 1962, taxpayer's opening inventory was reduced by the sum of \$104,190.76, thereby reducing its deduction for cost of goods sold by that amount. (I-R. 35, 40, 124.)

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^{2/} References to sections are to the Internal Revenue Code of 1954, unless otherwise indicated.

Old Baker and Kerman, on the ground that these subsidiary corporations were acquired in a Section 351 exchange and not by "purchase" within the purview of Section 334(b)(3)(B). As an alternate ground for its decision, the Tax Court held that even if the transaction by which taxpayer acquired stock in Old Baker and Kerman constituted a sale rather than a Section 351 exchange, taxpayer would still not be entitled to a stepped-up basis on the assets received upon liquidation of these two subsidiaries on the ground that such stock was acquired from related persons under the constructive stock ownership rules of Section 318. (I-R. 147-148.)

Facts Relating to the 1962 Transaction

A Panamanian corporation known as Veronica Compania Naviera S.A. ("Veronica") was organized by the three Jerome brothers in 1956. The purpose of the corporation was to engage in the chartering and operation of ocean-going vessels. As of December 1962, all of the Veronica stock was owned by the Jerome brothers in equal amounts. After being advised by their attorney that the Revenue Act of 1962 would cause adverse tax consequences to United States citizens owning stock in foreign corporations, the brothers indicated a willingness to sell their Veronica stock. (I-R. 118.)

By an "Agreement for the Sale of Stock" dated December 20, 1962, the taxpayer acquired all of the Veronica stock from the Jerome brothers. The total purchase price was \$1,100,000, of which \$350,000 represented the estimated value of a certain marketing

agreement between Veronica and a Philippine corporation, Legaspi Oil Company. The purchase price was payable in the form of promissory notes executed by taxpayer to each of the three Jerome brothers in the amount of \$366,666.67. (I-R. 121-122.)

On December 31, 1962, taxpayer liquidated Veronica, and all its assets and liabilities, including the marketing agreement, were transferred to taxpayer. For the fiscal year ended June 30, 1963, taxpayer deducted \$25,800 as amortization of the marketing agreement, using the basis of \$350,000 for such agreement. On audit of said return, the Commissioner determined that taxpayer was not entitled to a new basis for the assets received in liquidation of Veronica on the ground that such stock was not acquired by "purchase" as required by Section 334(b)(2), since it was acquired from related persons under the constructive stock ownership rules of Section 318. The Tax Court upheld the Commissioner's determination on this issue. (I-R. 40, 151-156.)

Facts Relating to the Constructive Ownership Question

The application of the constructive stock ownership rules of Section 318 as an alternative ground for denying the taxpayer a stepped-up basis in the 1961 transaction, and as the sole basis for denying it a stepped-up basis in the 1962 transaction, ultimately depends upon the correctness of the Tax Court's finding that three different partnerships were in existence at the time of those transactions. As to the 1961 transaction, Keith Engineering Company and either Manchester Medical Hospital or American Extraction Company

must have been in existence as of June 26, 1961; and as to the 1962 transaction, Keith Engineering Company and Manchester Medical Hospital (American Extraction Company was admittedly not in existence for the 1962 transaction) must have been in existence on December 20, 1962. Since the taxpayer concedes that Keith Engineering Company was in existence at the time of both the 1961 and 1962 transactions, (Br. 15, fn. 5) the following is a brief synopsis of the facts underlying the existence of Manchester and American:

Manchester was formed in 1958 as a limited partnership by 15 individuals, including the Jerome brothers and five of their key employees who later became stockholders of taxpayer. This partnership ran into severe financial difficulties and the hospital was closed about July 1960. On March 1, 1961, the partnership, by installment sale, conveyed all of its assets to Southwest Community Hospital Association. Southwest gave a promissory note for the purchase price, secured by a chattel mortgage and deed of trust on the hospital property. In order to report income received from the 1961 installment sale, a partnership tax return was prepared and filed for Manchester for 1961 and 1962. Manchester filed, what it called, its "final" return for the fiscal year ended August 31, 1962, reporting collections on installment sales in the amount of \$36,623.97. The 1962 tax return of the partnership reflected an unpaid balance of \$12,500 on the promissory note received by Manchester from Southwest. Furthermore, the partnership was not dissolved or terminated as of December 20, 1962. (I-R. 114, 115, 153-154.)

American Extraction Company was formed as a limited partnership in 1956 by 16 individuals, including the Jerome brothers, five of their key employees, and Jack Keith, all who later became stockholders of taxpayer. American terminated its operations in 1960, at which time it possessed approximately 3 million pounds of sewer skimmings which were turned over to Old Baker for sale under an oral agreement whereby Old Baker was to pay for it if and when sold. Taxpayer acquired the contractual rights to these skimmings from Old Baker, and taxpayer made payments to American for a period of time after June 26, 1961. The last partnership income tax return for American was filed for the calendar year 1960. When in early 1962 it was discovered that no formal steps had been taken to dissolve American, taxpayer's accountant notified taxpayer's legal counsel of that fact and requested that they prepare a formal certificate of cancellation of the limited partnership as of June 30, 1961, the end of Old Baker's fiscal year. Such a certificate was prepared, and on January 10, 1962, it was recorded. (I-R. 115-118.)

SUMMARY OF ARGUMENT

The principal question presented in this case involves the basis to be assigned certain assets acquired by the taxpayer on liquidation of three of its wholly-owned subsidiary corporations. Congress has enacted special provisions in the Internal Revenue Code (Section 334(b)) dealing with this question, and the general rule is that on liquidation of a subsidiary a parent corporation is required to carry over the same basis that the property had in the hands of the subsidiary. Taxpayer seeks to invoke an exception to this rule which

provides, in effect, that where a parent corporation acquires at least 80 percent of the stock in a subsidiary corporation from unrelated third parties by "purchase" (as defined in Section 334(b)(3)), then upon liquidation of the subsidiary the parent is entitled to use as its basis for the assets received the cost of the stock, rather than the subsidiary's basis for the assets. The term "purchase" expressly excludes transactions which fall within Section 351 (where in essence the subsidiary's stock was acquired from persons who have a continuing stake in the acquiring parent's business) and transactions where the parent acquired the subsidiary's stock from persons who are deemed to be related to the parent upon application of the constructive stock ownership rules of Section 318.

Since the taxpayer acquired the stock of these three subsidiary corporations (Old Baker and Kerman in 1961, and Veronica in 1962) from the Jerome brothers, it is the Commissioner's contention that the taxpayer did not acquire these corporations by "purchase", but instead in a transaction governed by Section 351 (as to stock acquired in Old Baker and Kerman), and from related persons under Section 318 (as to Veronica).

The facts underlying the 1961 transaction (regarding the taxpayer's acquisition of Old Baker and Kerman) clearly reveal that the three Jerome brothers did not want to sell or "cash-in" their various interests in the rendering business, including their stock in Old Baker and Kerman, but instead to merely lay the foundation for a perpetuation of their business by their employees after they retired. As a means of accomplishing this result it was agreed that

the three Jeromes and seven others (consisting of six of their employees and one associate in another related venture) would each invest \$500 and acquire 10 percent of the stock of taxpayer, and at the same time, as part of one integrated transaction, the Jeromes would transfer their Old Baker and Kerman stock (together with other business assets) to the taxpayer in return for a 15-year promissory note which imposed severe restrictions on the activities of taxpayer, and which required all of the stock of each of the ten stockholders to be pledged to the Jeromes as security for their note. The Jeromes continued to actively participate in the affairs of taxpayer after the transfers were made, and indeed retained their top managerial positions.

The Tax Court was warranted in finding that the transfer by the Jeromes was part of a single transaction whereby each of transferors of cash and property acquired 100 percent control of the taxpayer, and that affixing the label "sale" to the transaction did not in fact make it an isolated purchase and sale. The Tax Court was further warranted in finding that the note was a "security" for purposes of Section 351 on the ground that the entire transaction had the clear effect of giving the Jeromes a continuing beneficial interest in the taxpayer, and that they remained heavily involved in the management and affairs of the corporation. It cannot be said that the Tax Court was clearly erroneous in its findings that the taxpayer did not acquire the stock in Old Baker and Kerman by "purchase."

With regard to the 1962 transaction, the Tax Court properly determined that the taxpayer did not acquire its stock in Veronica from the Jeromes by "purchase." The statutory provisions applicable to the year involved require the conclusion that the Jeromes actually and constructively owned more than 50 percent of taxpayer's stock at the time the taxpayer acquired Veronica, and that the attribution to them under Section 318(a) of the taxpayer's stock owned by the seven other stockholders was a direct result of the close association of the Jeromes with these seven persons in the other partnership ventures. There is ample evidence and legal authority that these other partnerships were in existence on the appropriate dates, and there is no indication that the Tax Court violated the Congressional mandate in applying Section 318 to the facts of this case.

The Tax Court therefore was correct in denying the taxpayer a stepped-up basis for assets received in liquidation of the three subsidiary corporations that taxpayer acquired from the Jerome brothers.

ARGUMENT

THE TAX COURT CORRECTLY DETERMINED THAT THE TAXPAYER WAS NOT ENTITLED TO A STEPPED-UP BASIS FOR ASSETS ACQUIRED IN LIQUIDATION OF THREE OF ITS SUBSIDIARY CORPORATIONS (OLD BAKER, KERMAN, AND VERONICA) UNDER SECTION 334(b)(2) AND (3), INASMUCH AS TWO OF THESE CORPORATIONS (OLD BAKER AND KERMAN) WERE NOT ACQUIRED BY "PURCHASE", BUT IN A SECTION 351 EXCHANGE, AND INASMUCH AS THE THIRD CORPORATION (VERONICA) WAS ACQUIRED FROM PERSONS WHO WERE DEEMED RELATED TO THE TAXPAYER PURSUANT TO THE CONSTRUCTIVE STOCK OWNERSHIP RULES OF SECTION 318

A. Introduction

The substance of the transactions involved in this case reveals that the three Jerome brothers desired to consolidate their various rendering business interests in one corporation which would be owned, operated, and managed by them and seven other persons who had been closely associated with the Jeromes as employees and partners in the rendering business and other allied ventures. To accomplish this result, each of the ten individuals purchased 10% of the stock in taxpayer corporation, and virtually simultaneously therewith, and as an integral part of the entire transaction, the Jerome brothers conveyed to the taxpayer corporation all their stock in four corporations, together with other partnership assets, in return for a 15-year promissory note of the taxpayer and an agreement with the taxpayer and its stockholders imposing severe restrictions on taxpayer's activity until the note was fully paid. The assets acquired from the Jeromes represented the sole operating assets of taxpayer corporation. Shortly after the taxpayer acquired these

stocks from the Jeromes, it liquidated two of the corporations (Old Baker and Kerman) and took over the businesses previously operated by these subsidiaries. The question presented is whether the taxpayer is entitled to use as its basis for the assets received in the liquidation of these two corporations the same amount that it paid for the stock in these corporations (i.e., a pro rata part of the \$3,212,000 consideration), or whether it must use as its basis for the assets received the same basis as they had in the hands of these two subsidiary corporations before the liquidation. This question in turn depends upon whether the taxpayer can comply with the explicitly drawn provisions of Section 334(b) (see Appendix infra) of the Internal Revenue Code, which, in effect, permit a stepped-up basis only if it is determined that the taxpayer acquired the Old Baker and Kerman stock by "purchase" from the Jeromes, and not as an integral part of a Section 351 "exchange" (Appendix A, infra) or, in the alternative, from persons who are deemed to be related under the constructive stock ownership rules of Section 318 (Appendix A, infra).

The taxpayer's principal contention is that the Jeromes "sold" their partnership business (including the stock in Old Baker and Kerman) to the taxpayer in an isolated transaction of purchase and sale in return for a 15-year promissory note in the amount of \$3,150,000, and that as a result, the Jeromes were mere creditors of the taxpayer. The Tax Court, on the other hand, concluded that the transaction was not a purchase and sale, but in reality and substance part of a plan of forming and financing a corporation, and

after taking into account the agreement of "purchase and sale", the stock ownership of the Jeromes, and their active participation in the management of the taxpayer, the Tax Court found that the note received by the Jeromes was a "security" within the meaning of Section 351. We will demonstrate that the record fully supports the Tax Court's determination, and that the transaction meets all the other requirements of Section 351. (I-R. 137-147.)

As an alternative ground for denying the taxpayer a stepped-up basis for the assets received on liquidation of Old Baker and Kerman, the Tax Court stated (I-R. 148): "Even if we had determined that the transaction * * * constituted a sale rather than a section 351 exchange, New Baker would still not be entitled to a stepped-up basis * * *. This follows from the fact that although Section 334(b)(3)(B) would not apply, Section 334(b)(3)(C) would." This latter section defines a "purchase" of stock which is a prerequisite to a stepped-up basis under Section 334(b)(2), as not including an acquisition of stock from a related taxpayer. It requires the application of the stock attribution rules of Section 318, and when it is applied to the facts of this case the Jerome brothers are deemed to actually and constructively own a total of more than 50% of taxpayer's stock, thereby precluding the acquisition of Old Baker and Kerman stock from the Jeromes from being a "purchase".

The second transaction which is involved in this appeal relates to the acquisition by the taxpayer from the Jerome brothers in December 1962 of all the stock of Veronica, which corporation was subsequently liquidated by the taxpayer. The Tax Court correctly held that the taxpayer was not entitled to a stepped-up basis for the assets received on liquidation of this corporation because of

the application of Section 334(b)(3)(C) and the constructive stock ownership rules in the same manner stated in its alternative ground for denying the taxpayer a stepped-up basis in the earlier transaction described above.

- B. The Tax Court was warranted in finding that the taxpayer acquired the stock of Old Baker and Kerman in a non-taxable exchange under Section 351, rather than by purchase as required by Section 334(b)

Section 334(b) (Appendix A, infra provides for the basis of property received in liquidation of a subsidiary. The general rule, as stated in Section 334(b)(1), is that the parent corporation carries over the basis that the property had in the hands of the subsidiary before its liquidation. In a line of pre-1954 Code cases^{10/} led by the decision in Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), affirmed per curiam, 187 F. 2d 718 (C.A. 5th 1951), certiorari denied, 342 U.S. 827 (1951), the courts created an exception to this general rule and held that the purchase by one corporation of the stock of another corporation in order to obtain its assets through an immediate liquidation should be treated as a direct purchase of the assets, producing a basis equal to their cost rather than a carryover of the subsidiary's basis. In 1954 Congress codified this so-called Kimbell-Diamond rule in Section 10/ E.g., United States v. Mattison, 273 F. 2d 13 (C.A. 9th 1959); Georgia-Pacific Corp. v. United States, 264 F. 2d 161 (C.A. 5th 1959).

334(b)(2), subject, however, to very specific conditions and requirements.^{11/}

Section 334(b)(2) provides that the parent corporation's basis for the property received in liquidation of a subsidiary is the cost of the stock, rather than the subsidiary's basis for the assets, if, among other requirements, at least 80% of the stock of the subsidiary corporation was acquired by "purchase" (as defined in Section 334(b)(3)). Section 334(b)(3) defines "purchase" so as to exclude: (1) transactions in which the basis of the stock carries over from the transferor (e.g., an acquisition by gift, or tax-free reorganization) or is determined under Section 1014 (inherited property); (2) acquisitions of stock in exchanges to which Section 351 applies; and (3) acquisitions from "related persons" within the meaning of Section 318(a). This statutory Kimbell-Diamond rule, therefore, applies to stock acquired by a parent corporation from unrelated persons in transactions on which gain or loss on the transfer is recognized to the transferor.

^{11/} The Congressional purpose was clearly to substitute specific, objective tests (i.e., the liquidation must occur within two years of the acquisition, by purchase, of 80% control of the subsidiary) for the subjective test of the parent's motive in making the acquisition--which was subject to the difficulties of proof inherent in such "intent" determinations. (Cf. Section 337, enacted to obviate the factual inquiries generated by the Court Holding and Cumberland Pub. Service Co. line of cases.)

Applying Section 334(b)(2) to this case, it is the Commissioner's position that taxpayer did not acquire 80% or more of the stock of Old Baker and Kerman by "purchase," but, rather, by means of a Section 351 exchange. Section 351 provides that gain or loss is not recognized on the transfer of property to a corporation in exchange solely for stock or securities in such corporation, if immediately after the exchange the person or persons who transferred the property are in control of the corporation. Thus, resolution of the question whether Section 351 applies in this case depends upon the twofold determination (1) whether the transferor group was in "control" of the taxpayer-corporation "immediately after the exchange" and (2) whether the Jerome brothers transferred their Old Baker and Kerman stock to the taxpayer "solely in exchange for stock or securities."

The requisite "control" for purposes of Section 351 is defined by Section 368(c) as "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote * * *." The transferor group in this case was composed of all ten stockholders of taxpayer, who collectively owned 100% of its stock. The record fully supports the Tax Court's finding that the transfer of cash for stock by all ten stockholders and the almost simultaneous transfer of property by the three Jeromes "are to be

viewed as steps in a single transaction." (I-R. 145.)^{12/} The Tax Court succinctly summarized the substantial warrant in the record for arriving at its determination as follows (I-R. 146-147):

While the record fails to disclose the existence of any written agreement which sought to specifically define the rights and duties of the transferor group, the facts amply support the conclusion that as a result of lengthy negotiations prior to June 1961 between the keymen, the brothers, and Robert S. Wilson, the sole owner of the Wilson Company, a plan to transfer the Jerome Brothers partnership assets and the Wilson Company's interest in Kerman Tallow and San Joaquin Packing to a corporation to be owned equally by the three brothers and the keymen had been carefully formulated and agreed to by all the participants. There is no suggestion in the record that any aspect of the plan was left uncertain. If this is not so, it was incumbent upon petitioners to prove the contrary, and this they have failed to do. In light of this observation as well as the fact that the execution of the agreement proceeded with orderly dispatch, we are satisfied that within the transferor group, "immediately after the exchange", there was "possessed" the requisite stock ownership in New Baker so as to bring the transaction within the language of Section 351.

The courts have consistently held that application of the "step-transaction" theory is inherently a factual question, and that appellate review is restricted to a review of the trial court record to see if there is sufficient evidence to warrant its finding.

12/ It should be noted that the Wilson Company is not required to be a member of the transferor group in order for Section 351 to be applicable in this case. Neither party argued in the Tax Court that Wilson was required to be a member of the group, yet the court apparently felt that Wilson was required to be included. (I-R. 143, fn. 25.) Since the stepped-up basis provisions of Section 334(b)(2) are not applicable unless the taxpayer acquired at least 80% of Kerman by "purchase," even if we were to concede that 50% of the stock of Kerman was acquired from Wilson by "purchase," the taxpayer would still not be entitled to a stepped-up basis for Kerman's assets inasmuch as the remaining 50% of Kerman's stock was acquired from the Jerome brothers in a Section 351 exchange.

Commissioner v. Court Holding Co., 324 U.S. 331 (1945). This rule applies also to factual inferences from undisputed basic facts.

Commissioner v. Duberstein, 363 U.S. 278 (1960). The step-transaction principle has been applied in several Section 351 cases involving facts quite similar to the instant case. For example, this Court has held that two transactions five weeks apart constituted a single transaction under the predecessor to Section 351. Von's Inv. Co. v. Commissioner, 92 F. 2d 861 (1937). See also Halliburton v. Commissioner, 78 F. 2d 265 (C.A. 9th 1935); Portland Oil Co. v. Commissioner, 109 F. 2d 479 (C.A. 1st 1940); Houck v. Hinds, 215 F. 2d 673 (C.A. 10th 1952); American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948),
^{13/}
affirmed per curiam, 177 F. 2d 513 (C.A. 3d 1949).

Section 351 is thus complied with even though some members of the transferor group transfer only cash in return for their stock, while others transfer operating business assets in return for stock and/or securities.
^{14/}
Nor are the exchange provisions of Section 351 avoided

^{13/} Consistent with these cases, Section 1.351-1(a)(1), Treasury Regulations on Income Tax (1954 Code), provides: "The phrase 'immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure. The courts have stated that a legally binding agreement is not necessary. E.g., Portland Oil Co. v. Commissioner, supra. The cases require only a general plan among the parties. Von's Inv. Co. v. Commissioner, supra; Royal Marcher v. Commissioner, 32 B.T.A. 76 (1935).

^{14/} Halliburton v. Commissioner, supra; Houck v. Hinds, supra; Portland Oil Co. v. Commissioner, supra; Marsan Realty Co. v. Commissioner, decided October 29, 1963 (22 T.C.M. 1513).

by affixing the label "sale" to some of the property transferred, if, as in this case, the "sale" is an integral part of a single transaction in forming and financing the corporation. Truck Terminals, Inc. v. Commissioner, 314 F. 2d 449 (C.A. 9th 1963); Camp Wolters Enterprises v. Commissioner, 230 F. 2d 555 (C.A. 5th 1956); Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders (2d ed. 1966), pp. 100-104. Likewise, under the 1954 Code, there is no requirement that each transferor receive the same proportion of stock or securities.^{15/} Thus, merely because the three Jerome brothers did not themselves acquire 80% control of the stock of taxpayer does not preclude them from being part of the transferor group. The Tax Court was, therefore, not clearly erroneous in applying the step-transaction theory to the facts of this case in determining that all ten transferors of cash and other property constituted the "control group" for purposes of Section 351.

The next question is whether the ten transferors in this case transferred their property to the taxpayer "solely in exchange for stock or securities." Since it is undisputed that seven of these

^{15/} The legislative history relating to the 1954 Code changes in Section 351 explains the elimination of the so-called "proportionate interest" test as follows: "In eliminating the proportionate interest test, your committee intends that no gain or loss will be recognized to a transferor transferring property to a corporation under section 351, irrespective of any disproportion of the amount of stock or securities received by him as a result of the transfer." H. Rep. No. 1337, 83d Cong., 2d Sess., p. A117 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4254-4255). Some courts have held that it is not even necessary that all transferors receive stock, so long as some of the transferors are in control after the transfer. Burr Oaks Corp. v. Commissioner, 43 T.C. 635 (1965), affirmed, 365 F. 2d 24 (C.A. 7th 1966); Marsan Realty Corp. v. Commissioner, *supra*; see also Section 1.351-1(b)(1), Treasury Regulations on Income Tax (1954 Code).

transferors (Keith and the six employees of the Jeromes) received only "stock" in the taxpayer-corporation, and since (as an integral part of the same transaction) the three Jerome brothers received "stock" and "something else," it becomes necessary to determine just what that "something else" was. If it is deemed to be in the nature of cash or its equivalent, then, admittedly, to that extent, Section 351 would not be applicable.^{16/} If, however, the facts and circumstances surrounding the transfer by the Jeromes are susceptible of the interpretation that the "something else" they received was a "security," as that term is defined for these purposes, then Section 351 would be fully applicable.

The taxpayer, while admitting that the question involved is an "issue of fact" (Br. 29), relies heavily on the theory that in effect the evidence presented compelled the Tax Court to find that the Jerome brothers "sold" their business to the taxpayer-corporation. This contention overlooks the fact that the Jeromes retained for themselves a highly significant degree of participation in and control over the affairs of the taxpayer-corporation in its operation of the business purportedly "sold" to it. To accept the taxpayer's reasoning in this case would subvert Congressional purpose by permitting taxpayers to convert Section 351 into an optional provision merely by labelling a

^{16/} Cash or its equivalent would be "boot" and gain would be recognized to the extent thereof. Section 351(b)(1). The transferors' basis for their stock is then increased by such recognized gain (Section 358(a)(1)(B)(ii)), and the basis to the transferee corporation of the assets is similarly increased by the gain recognized by the transferors (Section 362(a)).

transfer to a corporation as a "sale."^{17/} This is especially true in a case, such as we have here, where the assets transferred by the Jeromes represented the sole operating assets of the taxpayer, and where such transfer was not an isolated purchase and sale made after the taxpayer was formed and operating. As was said in American Compress & Warehouse Co. v. Bender, 70 F. 2d 655, 657 (C.A. 5th 1934)--

The transaction described in the statute lacks a distinguishing characteristic of a sale, in that, instead of the transaction having the effect of terminating or extinguishing the beneficial interests of the transferors in the transferred property, after the consummation of the transaction the transferors continue to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner of it.

Since Section 351 specifically includes both "stock" and "securities," it is not necessary that the fifteen-year promissory note received by the Jeromes in this case be deemed to be in the nature of "stock;" it may also be a "security." Thus, the Tax Court was not inconsistent in holding this note to be an "indebtedness" for purposes of allowing the taxpayer an interest deduction, while at the same time holding it to be a "security" for Section 351 purposes. (I-R. 137.)^{18/}

^{17/} See Bittker and Eustice, supra, p. 102, where the authors point out that "In more naive days, it was sometimes thought that the organizers of a corporation, wishing to deduct a loss on depreciated property, could purchase the corporation's stock for cash and then successfully 'sell' the property to it for the cash just paid in, but the quietus was put on such transactions as early as 1932, in Labrot v. Burnet, 57 F. 2d 413 (D.C. Cir. 1932) * * *."

^{18/} Camp Wolters Enterprises v. Commissioner, 230 F. 2d 555 (C.A. 5th 1956); Campbell v. Carter Foundation Production Co., 322 F. 2d 827 (C.A. 5th 1963).

In addition, the Tax Court's holding that the Jerome brothers were entitled to long-term capital gain treatment on the amounts received in payment of this fifteen-year note was based on Section 1232 (amounts received by holder of indebtedness deemed to be received "in exchange therefor"), and not, as argued by the Jeromes, on the ground that they "sold" a capital asset.

- C. The Tax Court was warranted in finding that the fifteen-year promissory note, issued by the taxpayer in conjunction with its acquisition of stock in Old Baker and Kerman, constituted a "security" for purposes of Section 351

It is now well settled that promissory notes may qualify as securities under Section 351. Parkland Place Co. v. United States, 354 F. 2d 916 (C.A. 5th 1966); Campbell v. Carter Foundation Production Co., 322 F. 2d 827 (C.A. 5th 1963); Burnham v. Commissioner, 86 F. 2d 776 (C.A. 7th 1936); Camp Wolters Enterprises, Inc. v. Commissioner, 22 T.C. 737, 751 (1954), affirmed, 230 F. 2d 555 (C.A. 5th 1956). In Camp Wolters, the Fifth Circuit adopted the following Tax Court "guide" in determining whether a debt instrument qualifies as a "security" (p. 560):

Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc. It is not necessary for the debt obligation to be the equivalent of stock since section 112(b)(5) [the predecessor to Section 351] specifically includes both "stock" and "securities." (Emphasis supplied.)

It is essential to note, contrary to the apparent assertion of the taxpayer (Br. 27, 42), that since Section 351 imposes an 80% control requirement only with respect to "stock," the control or "proprietary interest" need not be exercised through the "securities." The continuity

of interest doctrine can be traced back to Cortland Specialty Co. v. Commissioner, 60 F. 2d 937 (C.A. 2d 1932), a corporate reorganization case, where one corporation transferred substantially all its assets to another corporation in return for cash and short-term promissory notes. The transferor received no stock in the transferee corporation. In holding that the transaction amounted to a true sale, rather than a tax-free reorganization, the court stated (p. 940):

[To have a reorganization] the property received by Cortland had to include some "stock or securities" * * *. As no stock was issued against the transfer, the conditions for an exemption were not fulfilled unless the notes, all payable within fourteen months of the date of the transfer, and all unsecured, can be considered "securities" * * *. Inasmuch as a transfer made entirely for cash would not be enough, it cannot be supposed that anything so near to cash as these notes payable in so short a time and doubtless readily marketable would meet the legislative requirements.

* * * The situation might be different had the "securities," though not in stock, created such obligations as to give creditors or others some assured participation in the properties of the transferee corporation. The word "securities" was used so as not to defeat the exemption in cases where the interest of the transferor was carried over to the new corporation in some form.

One year later, the Supreme Court adopted the principle established in Cortland, and stated, "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes" if the transaction is to qualify as a reorganization. Pinellas Ice Co. v. Commissioner, 287 U.S. 462, 470 (1933). The Court went on to hold that four-month notes were not securities. The continuity of interest concept assumed less significance, however, after the enactment of the Revenue Act of 1934, c. 277, 48 Stat. 680, Sec. 112(g), which amended the definition of "reorganization" (now found in Section

368(a) of the 1954 Code) so that nothing but voting stock of the acquiring corporation could be used as consideration in an acquisition of the stock or assets of another corporation.

While the continuity of interest doctrine might still have some application to the determination of what is a "security" under Section 351, there is no requirement that the security itself be in the nature of a proprietary interest, so long as the transferor retains some continuing stake and degree of participation in the transferee corporation beyond that of a mere creditor. ^{19/} In any event, since the three Jerome brothers do have a significant proprietary interest in taxpayer, the requirement set forth in the earlier reorganization cases is satisfied. It is not necessary that a "security" holder also have 80% control of a corporation (as the taxpayer would lead us to believe); at the very most, Section 351 merely requires that a

^{19/} As previously stated, it is not necessary to include Wilson Company in the category of a security holder in this case, inasmuch as Section 334(b)(2) operates to preclude the taxpayer from acquiring a stepped-up basis in Kerman if the 50% interest in Kerman's stock acquired from the Jeromes falls within Section 351. See fn. 12, supra. A transferor who retains no proprietary interest at all would have made a sale, and his entire gain would be recognized, while if he retains such an interest and receives something other than stock or securities, he would recognize gain only to the extent of the boot property. There would concededly be no continuity of interest as to a transferor who receives nothing but bonds; on the other hand, all the transferors here (except Wilson Company) received stock, and therefore Section 351 need not apply to the Wilson transfer.

"security" holder be one member of the transferor group which controls 80% of the corporation's voting stock.

It is difficult to imagine a stronger case for treating the fifteen-year promissory note in this case as a security. The Tax Court summarized its finding on this point as follows (I-R. 142-143):

While admittedly not controlling, the fact that the term of the note is for 15 years itself strongly supports our conclusion. * * * More important, however, is the fact that the note in question, together with the agreement of purchase and sale, clearly secured to the noteholder, the Jerome Brothers partnership, the continuing participation in the business which is so characteristic of a security interest. Thus, until the note was paid in full, New Baker could not, without the consent of the partnership, change the compensation of officers, declare stock or cash dividends, mortgage property except in the usual and ordinary course of business, amend the articles of incorporation, issue additional stock, create new debts or make loans above certain specified amounts, purchase stock of other businesses except within well-defined limits, enter partnership agreements, or merge with other corporations. While the intention of the Jerome brothers to continue their participation in the business was adequately secured by the foregoing restrictions, there is additional evidence to support our conclusion. Each of the brothers obtained for himself a 10 percent interest in the new business and continued to actively participate in the management of the business not only as directors, but also as key employees and officers. 20/ The foregoing facts

20/ As of the time of trial, approximately five years after the 1961 transaction, Varney Jerome was general manager of Phoenix Tallow, Paul Jerome was general manager of New Baker's Albuquerque operations, and Frank Jerome was New Baker's president. While the employees of New Baker assumed more responsibility in the management of that company than they had while employees of Old Baker (I-R. 109), their positions in New Baker were virtually identical to the positions they had held in Old Baker while employed by the Jeromes (I-R. 65, 108).

make it clear that the noteholders secured for themselves a significant degree of participation in New Baker's affairs before transferring their partnership assets to it. Considering all of the foregoing factors, we are compelled to hold that the promissory note in question falls within the meaning of "securities" as used in section 351.

Although the evidence cited by the Tax Court is sufficient by itself to warrant a finding that the note was a security, there is additional evidence in the record to buttress the finding that the Jerome brothers had a continuing stake in the taxpayer-corporation. All of the taxpayer's stock was pledged as security for the notes (I-R. 21, 101, 106, fn. 9); the bank that was owed money by the taxpayer considered the Jerome brothers as the principals of taxpayer and demanded their personal guarantee on taxpayer's loans (I-R. 110); and the identical rendering business that was conducted by the Jeromes before the transfer to the taxpayer was continued, without interruption, after the transfer.

Each of the cases cited by the taxpayer involved a factual pattern quite different from this case. The taxpayer asserts (Br. 30) that "In four cases decided prior to the instant case, and one decided subsequently, the Tax Court flatly rejected the contention that a note received for the purchase price in a bona fide sale could be regarded as a 'security' within the meaning of Section 351." This statement by the taxpayer obviously begs the issue, since it is a factual determination whether a particular note in a particular case is received as part of a bona fide sale or as a "security," and merely because the Tax Court determined that the notes in five other cases were received in a "sale" does not, as a matter of law, make the note in this case a non-security. In none of the Tax Court

cases referred to by the taxpayer was it found that the holders of the notes had the degree of continued participation in the operation of the transferee corporation as the Jerome brothers had in the instant case. For example, in Brown v. Commissioner, 27 T.C. 27 (1956), acquiescence, 1957-2 Cum. Bull. 4, one of the partners in a logging business was fearful of putting all the partnership equipment into a new corporation. A compromise was effected between the partners, and a portion of the equipment was sold under an "installment sales contract" whereby the partners reserved title to the equipment in their own names. After finding that the partners did not intend to place the equipment at the risk of the corporate entity, and after further finding that the equipment sold was not necessary to the operation of the corporation, the Tax Court held that the installment contract was not a "security" and "was not intended to insure the partners a continued participation in the business of the transferee corporation." 27 T.C., p. 37 . The facts in Brown are clearly distinguishable from those of the instant case, where the Jeromes transferred their entire business to the taxpayer, and where the note and agreement secured for them a continuing stake in the taxpayer beyond that of a secured creditor. Likewise, in Curry v. Commissioner, 43 T.C. 667 (1965), a husband, wife, and their son and daughter owned a piece of real estate. The daughter's husband (who had been actively engaged in his own real estate activities) and the son formed a corporation to buy this real estate, each taking 45% of the stock, with the remaining 10% issued to the father. The corporation then purchased the real estate from the four family members, with

the bulk of the purchase price payable in installments over a period of twenty years, secured by deeds of trust on the transferred property. The court held that the installment obligation was issued as part of a bona fide sale and was not stock or a security for purposes of Section 351. The case is distinguishable from the instant case in that the sellers of the property ceased to have a continuing stake in the affairs of the transferee corporation that in any way approached that of the Jeromes had in this case. Two of the transferors in Curry received no stock at all, and the father, who originally dominated the venture, was inactive in the transferee corporation. Furthermore, unlike the instant case, no restrictions whatever were placed by the transferors on the activities of the new corporation.

Another Tax Court case which the taxpayer claims is "identical" to the instant case is Stevens Pass, Inc. v. Commissioner, 48 T.C. 532 (1967). In that case two shareholders who controlled a corporation became involved in an "irreparable dispute." They wanted to part ways and sell out. To that end, they interested an outside group of investors to form a new corporation which purchased their stock in the old corporation, with the purchase price for the stock payable in a ten-year installment note. One of the shareholders in the old corporation received no stock in the new corporation, and, while the other shareholder did own some stock in the new corporation, the new corporation was dominated by the outside investors' group, which had possessed no interest whatever in the old company. The Tax Court found that the transfer of stock by the shareholders of the old company amounts to a sale and that, therefore, the transferee corporation was entitled to a stepped-up

basis for the stock it "purchased." The court, in effect, found that the sale of the stock was an independent action having no connection with a plan to launch or finance a new corporation. Unlike the instant case, where the facts warrant a finding that the transfer of the Jerome Brothers partnership and the formation of the taxpayer were all parts of one interrelated plan to have the Jeromes remain as the dominant figures in the taxpayer-corporation, Stevens Pass involved a factual background which led the Tax Court to conclude that the transferors were interested in terminating, rather than perpetuating, their interests in corporate form. Unlike the instant case, the transferors in Stevens Pass imposed no restrictions on the transferee corporation and had no significant control over its affairs.

The taxpayer claims (Br. 43) that the effect of the Tax Court's decision in this case will be to broaden the scope of Section 351 by applying it to sales to corporations by unrelated third parties. The fallacy in the taxpayer's assertion becomes apparent when we focus upon the facts which the Tax Court had before it in this case. The Jerome brothers were dominant members of the transferor group which controlled the taxpayer; each member of the transferor group was closely associated with the Jeromes in the operation of the business before the transfer; the Jerome brothers, as a part of their agreement to transfer their rendering business to taxpayer, retained extensive and highly restrictive controls over the taxpayer; and while the other stockholders of taxpayer had responsible management positions, the Jeromes remained heavily involved in the management of taxpayer. This

factual pattern is quite different from a long-term sale to a corporation by a seller who has no control over the corporate buyer.

The Tax Court's determination that the transfer in this case was not a "sale," but part of an over-all plan of forming a corporation under Section 351, is not clearly erroneous.^{21/} We, therefore, submit that the Tax Court was warranted in finding that the stock in Old Baker and Kerman was acquired by the taxpayer from the Jeromes in return for a "security," and that, viewing the entire transaction, the Tax Court correctly determined that such transaction came within Section 351, thereby precluding taxpayer from acquiring a stepped-up basis under Section 334(b)(2) and (b)(3)(B) of the 1954 Code.

^{21/} This Court has held, in a case quite similar to the instant case, that the question of whether a bona fide sale exists is one of fact. Truck Terminals, Inc. v. Commissioner, 314 F. 2d 449 (1963). While that case involved the proper classification of a three-year installment contract given in exchange for the transfer of certain assets to the taxpayer, this Court indicated therein that promissory notes may be held to be "securities" for Section 351 purposes. For cases which further support the Tax Court's conclusion herein, see, e.g., United States v. Hertwig, 298 F. 2d 450 (C.A. 5th 1968); United States v. Mills, 399 F. 2d 944 (C.A. 5th 1968) (one-year note held to be a "security," and jury verdict upheld); Nye v. Commissioner, 50 T.C. 203 (1968).

- D. The Tax Court properly determined that the taxpayer acquired the stock of Old Baker and Kerman in 1961, and the stock of Veronica in 1962, from persons who were deemed to be related to the taxpayer pursuant to the constructive stock ownership rules set forth in Section 318, thereby precluding taxpayer from a stepped-up basis for the assets received upon liquidation of these corporations pursuant to Section 334(b)(3)(C)

Section 334(b)(2) provides that a parent corporation is required to carry over the subsidiary's basis for assets received in liquidation of the subsidiary unless the parent acquired the subsidiary's stock by "purchase" (as defined in Section 334(b)(3)), in which case the parent is permitted to step up its basis for the assets received to the cost of the stock. Section 334(b)(3) defines "purchase" so as to exclude three types of transactions: (1) transactions in which the basis of the stock carries over from the transferor (e.g., gifts); (2) acquisition of stock in exchanges to which Section 351 applies; and (3) acquisitions "from a person the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock." We have previously discussed the application of the second exception (Section 351 transfers) to the acquisition by taxpayer of the stock of Old Baker and Kerman in the 1961 transaction. We will now demonstrate that the third exception (Section 334(b)(3)(C)) to what is deemed a "purchase" (i.e., acquisitions from "related persons" under Section 318(a)) was correctly applied by the Tax Court as an alternative ground for denying the taxpayer a stepped-up basis on the assets of Old Baker and Kerman acquired in 1961, and that the Tax Court correctly applied this third exception as the sole ground for denying the taxpayer a stepped-up basis on the assets acquired on the liquidation of Veronica in 1962.

In order to have Section 334(b)(3)(C) applicable to this case, it must be determined that the Jerome Brothers partnership owned 50% or more of taxpayer's stock, directly, or constructively, at the time of the 1961 and 1962 transactions. Section 318(a)(2)(C).^{22/} (Appendix A, infra). If the Jerome partnership is deemed to own 50% of taxpayer's stock, then, by virtue of Section 318(a)(2)(C), the taxpayer is deemed to own all the stock owned by the Jerome partnership in Old Baker, Kerman, and Veronica. (Although the partnership itself owned no stock in taxpayer, Section 318(a)(2)(A) attributes to the partnership any stock owned by its partners.)

Section 318(a)(4) provides that in determining stock ownership, stock which is constructively owned is to be considered as actually owned for the purposes of applying these rules. Since the Jerome Brothers partnership owned directly 30% of taxpayer's stock, we must now ascertain whether it owned constructively at least 20% more. The Jerome brothers were engaged in other partnership businesses with seven of the remaining stockholders of taxpayer. Since the attribution rules in Section 318 require the application of those rules to those partnerships as well, we must now determine whether the Jeromes are deemed to own constructively any of the stock of these seven other stockholders of taxpayer by reason of their partnership relationships with the Jeromes.

The Jerome brothers were 50% partners with Jack Keith in a partnership known as Keith Engineering Company. (I-R. 94.)^{23/}

^{22/} Since Section 318 was amended in 1964 (Act of August 31, 1964, P.L. 88-554, 78 Stat. 761, Sec. 4(a)), the references here are to the relevant provisions of that section as it existed in 1961 and 1962.

^{23/} The taxpayer concedes (Br. 15, fn. 5) that Keith Engineering Company was in existence at the time of both the 1961 and the 1962 transactions.

Section 318(a)(2)(A) requires that stock owned by a partner "shall be considered as being owned by the partnership," and further requires that stock owned by a partnership, "directly or indirectly," is "considered as being owned proportionately by its partners." Applying this rule to this case, Keith's 10% stock ownership in taxpayer is deemed to be owned by the partnership, and, as a result, the three Jerome brothers (50% partners in Keith) are deemed to own constructively 5% more of taxpayer's stock, bringing their total, thus far, to 35%.

The Jerome brothers were also partners with five stockholders of taxpayer (who were also employees of the Jeromes) in a limited partnership known as Manchester Medical Hospital. Each of the Jerome brothers owned 11.11% of the partnership (I-R. 114), and, as a consequence of applying Section 318(a)(2)(A) in the same manner as applied with regard to Keith Engineering Company, the three Jeromes are each deemed to own constructively 11.11% of the 50% (5.5%) of the taxpayer's stock owned by these other five partners. Thus the Jerome brothers are deemed to own 16.5% of taxpayer's stock through their Manchester Medical Hospital affiliation, and 5% through Keith Engineering, for a total of 21.5%. When added to their 30% direct ownership, this 21.5% produces a total of 51.5% of taxpayer's stock which is owned by the Jeromes. This results in the taxpayer's having acquired its Old Baker, Kerman, and Veronica stock from persons (the Jeromes) "the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock," pursuant to Section 334(b)(3)(C). See charts of this transaction, Appendix B, infra.

The taxpayer's primary objection to this result is based on the notion that Manchester Medical Hospital was not in existence for purposes of applying these attribution rules to the 1961 and 1962 transactions. ^{24/}

The taxpayer attempts to support its contention on the ground that Manchester ceased to engage in an active trade or business on March 1, 1961, and that, although it was not legally dissolved or terminated, it was, therefore, not in existence for purposes of Section 318.

(Br. 45-51.)

The Tax Court found that Manchester was "still winding up its * * * affairs" on December 20, 1962, and "continued to exist for the purpose of collecting money due the partnership." (I-R. 153-154.) It therefore correctly determined that Manchester was in existence for purposes of Section 318.

While Section 318 does not itself define "partnership," Section 761(a) defines a partnership to include an organization "through or by means of which any business, financial operation, or venture is carried on * * *." Section 708(b) (Appendix, infra) (which is made applicable expressly only to Subchapter K by Section 708(a) (Appendix A, infra)), relied on by the taxpayer to establish that Manchester was not in existence in 1961 and 1962, would actually buttress the Commissioner's

^{24/} Another partnership, American Extraction Company, in which the Jerome brothers were 70% partners, and six stockholders of taxpayer were also partners, could also be utilized for purposes of applying the attribution rules of Section 318 and thus bar the taxpayer from complying with Section 334(b)(3)(C). Although the Tax Court's findings of fact indicate that this partnership was in existence during the 1961 transaction, it was not in existence at the time of the 1962 transaction. (I.R. 117-118.) For this reason the Tax Court chose to base its decision on the existence of Manchester Medical Hospital (for both transactions). In the event that this Court finds that Manchester Medical Hospital was not in existence at the time of the 1961 transaction, we submit that the facts amply support a conclusion that American Extraction was in existence as of June 30, 1961, and was not dissolved

position, inasmuch as it states that "a partnership shall be considered as terminated only if * * * no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or * * * within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits." The Treasury Regulations under this section make it clear that termination does not take place until the winding up period ends and all partnership assets are distributed to the partnership. Section 1.708-1(b) (Appendix A, infra). The taxpayer also erroneously contends that Section 708(b)(1)(B) is applicable to this case, where in point of fact it clearly refers to a case where one of the partners terminates his interest by selling his share of the partnership to someone else. In the instant case none of the partners sold their interests during the period in question; they retained their partnership relationship, or "agency relationship," as taxpayer asserts (Br. 49), at all times here relevant.^{25/}

The resolution of the question as to whether Manchester was an existing partnership in 1961 and 1962 is expressly answered by the California Uniform Partnership Act, 25 West's Annotated California Codes, Sections 15001-15045 (not referred to by the taxpayer in its brief), which provides in pertinent part as follows:

^{25/} The reference by the taxpayer (Br. 48) to this Court's decision in Hatch's Estate v. Commissioner, 198 F. 2d 26 (1952), has no relevance to the question at hand. That case did not decide when a partnership ceases to exist for tax purposes.

Section 15029. Dissolution defined. The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.

Section 15030. Effect of dissolution. On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed.
(Emphasis supplied.)

It is clear that the Uniform Partnership Act requires a break in the partners relationship so that one partner ceases to be associated with the venture. Cotten v. Perishable Air Conditioners, 18 Cal. 2d 575, 116 P. 2d 603 (1941); Vangel v. Vangel, 116 Cal. A. 2d 615, 254 P. 2d 919 (1953). All of the cases cited by the taxpayer (Br. 48-50) are inapplicable to the facts of this case, **either** because they are pre-Uniform Partnership Act cases or deal with questions whether a particular partner was part of the partnership agency at a particular time.

The Manchester Medical partnership had not finally settled its affairs by December 20, 1962 (and indeed continued to be accountable for any monies received), and under California law it was deemed

to be in existence at that time. The Tax Court was, therefore, not in error in finding that it was a legal partnership for purposes of Section 318. ^{26/}

As its final argument, the taxpayer claims that even if Manchester were in existence, Section 318(a) should not be applied in this case because to do so requires "triple attribution", and that the 1964 amendments to Section 318 (Act of August 31, 1964, P.L. 88-554, 78 Stat. 761, Sec. 4(a)) eliminating the type of "sidewise" or "double" attribution present here merely clarified Congressional intent. (Br. 52-55.) An examination of the legislative Committee Reports ^{27/} relating to the 1964 amendments clearly reveals that they were not intended to apply to transactions which occurred prior to the effective date of the amendment (August 31, 1964). Section 4(c) of P.L. 88-554 states:

The amendments made by this section shall take effect on the date of the enactment of this Act, except that, for purposes of section 302 and 304 of the Internal Revenue Code of 1954, such amendments shall not apply with respect to distributions in payment for stock acquisitions or redemptions, if such acquisitions or redemptions occurred before the date of the enactment of this Act. (Emphasis supplied.)

^{26/} In Sorem v. Commissioner, 40 T.C. 206 (1963), reversed on other grounds, 334 F. 2d 275 (C.A. 10th 1964), the Tax Court stated (p. 215 fn. 14):

As we view the statute [Section 318], attribution is required by virtue of the mere existence of a partnership relation between corporate shareholders, and business activity has nothing to do with it. Certainly sec. 318 itself makes no reference to "business activity" as a prerequisite for partnership attribution, and in the absence of convincing authority we are unwilling to add this judicial gloss to an already complex section of the Code.

^{27/} S. Rep. No. 1240, 88th Cong., 2d Sess. (1964-2 Cum. Bull. 701) (July 24, 1964); H. Conference Rep. No. 1844, 88th Cong., 2d Sess. (1964-2 Cum. Bull. 706) (August 20, 1964).

The clear meaning of this section is that the pre-1964 attribution rules remain applicable for all transactions, even for certain distributions made after August 31, 1964, where the transaction originated prior to that date. The taxpayer asserts that "The court attributed appellant's stock actually owned by each of 5 unrelated keymen to Manchester * * *". (Br. 53.) Although the statute involved sanctions (and indeed requires) the three-step approach utilized in this case, it should be noted that the five keymen were quite closely "related" to the Jerome brothers in their rendering businesses and were partners of the Jeromes in one other venture (American) in addition to the Manchester venture. Nor has the concept of triple attribution ceased to exist in Section 318 even after the 1964 amendments. In fact one tax publication (Tax Management) states, "The process of reattribution is not limited to double attributions. * * * [T]he process may be virtually endless". See 72-2d T.M., Constructive Ownership Rules under Section 318, p. A-18, Example 3.

Taxpayer has failed to demonstrate that Congress did not intend the transactions involved in this case from coming within Section 318. Thus, since both Manchester and Keith Engineering were in existence on December 20, 1962, taxpayer was the constructive owner of the Old Baker, Kerman, and Veronica stock that it acquired from the Jerome brothers. The taxpayer therefore did not acquire stock in those corporations by "purchase" as required by Section 334(b)(2). We submit that the Tax Court was warranted in finding that taxpayer was not entitled to a stepped-up basis on the assets it received

CONCLUSION

The Tax Court's determination is correct and not clearly erroneous, and its decision should therefore be affirmed.

Respectfully submitted,

MITCHELL ROGOVIN,
Assistant Attorney General.

LEE A. JACKSON,
JONATHAN S. COHEN,
LESTER B. SNYDER,
Attorneys,
Department of Justice,
Washington, D. C. 20530.

JANUARY, 1969.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this _____ day of January, 1969, in an envelope, with air mail postage prepaid, properly addressed to them as follows:

Carl A. Stutsman, Jr., Esquire
Jack R. White, Esquire
Glenn M. Alperstein, Esquire
Hill, Farrer & Burrill, Gillin &
Scott
445 South Figueroa Street
Los Angeles, California 90017

MITCHELL ROGOVIN
Assistant Attorney General

APPENDIX A

Internal Revenue Code of 1954:

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) General Rule.--For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable--

* * * * *

(2) Partnerships, estates, trusts, and corporations.--

(A) Partnerships and estates.--Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as being owned proportionately by its partners or beneficiaries. Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as being owned by the partnership or estate.

* * * * *

(C) Corporations.--If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then--

* * * * *

(ii) such corporation shall be considered as owning the stock owned, directly or indirectly, by or for that person.

* * * * *

(4) Constructive ownership as actual ownership.--

(A) In general.--Except as provided in subparagraph (B), stock constructively owned by a person by reason of the application of paragraph (1), (2), or (3) shall, for purposes of applying paragraph (1), (2) or (3), be treated as actually owned by such person.

* * * * *

(26 U.S.C. 1964 ed., Sec. 318.)

SEC. 334. BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS.

* * * * *

(b) Liquidation of Subsidiary.--

(1) In general.--If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332 (b)), then, except as provided in paragraph (2), the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor. If property is received by a corporation in a transfer to which section 332(c) applies, and if paragraph (2) of this subsection does not apply, then the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor.

(2) Exception.--If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), and if--

(A) the distribution is pursuant to a plan of liquidation adopted --

(i) on or after June 22, 1954, and

(ii) not more than 2 years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and

(B) stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase (as defined in paragraph (3)) during a period of not more than 12 months,

then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary or his delegate, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

(3) Purchase defined.--For purposes of paragraph (2)(B), the term "purchase" means any acquisition of stock, but only if--

(A) the basis of the stock in the hands of the distributee is not determined (i) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (ii) under section 1014(a) (relating to property acquired from a decedent),

(B) the stock is not acquired in an exchange to which section 351 applies, and

(C) the stock is not acquired from a person the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock.

* * * * *

(26 U.S.C. 1964 ed., Sec. 334.)

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) General Rule.--No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

* * * * *

(26 U.S.C. 1964 ed., Sec. 351.)

SEC. 708. CONTINUATION OF PARTNERSHIP.

(a) General Rule.--For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

(b) Termination.--

(1) General rule.--For purposes of subsection (a), a partnership shall be considered as terminated only if--

(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

* * * * *

(26 U.S.C. 1964 ed., Sec. 708.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.708-1 Continuation of partnership.

(a) General rule. For purposes of subchapter K, chapter 1 of the Code, an existing partnership shall be considered as continuing if it is not terminated.

(b) Termination.--(1) General rule. (i) A partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. For example, on November 20, 1956, A and B, each of whom is a 20-percent partner in partnership ABC, sell their interests to C, who is a 60-percent partner. Since the business is no longer carried on by any of its partners in a partnership, the ABC partnership is terminated as of November 20, 1956. However, where partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30, 1957.

* * * * *

(26 C.F.R., Sec. 1.708-1.)

(3) Purchase defined.--For purposes of paragraph (2)(B), the term "purchase" means any acquisition of stock, but only if--

(A) the basis of the stock in the hands of the distributee is not determined (i) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (ii) under section 1014(a) (relating to property acquired from a decedent),

(B) the stock is not acquired in an exchange to which section 351 applies, and

(C) the stock is not acquired from a person the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock.

* * * * *

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* * * * *

(26 U.S.C. 1964 ed., Sec. 351.)

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(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

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* * * * *

(26 U.S.C. 1964 ed., Sec. 708.)

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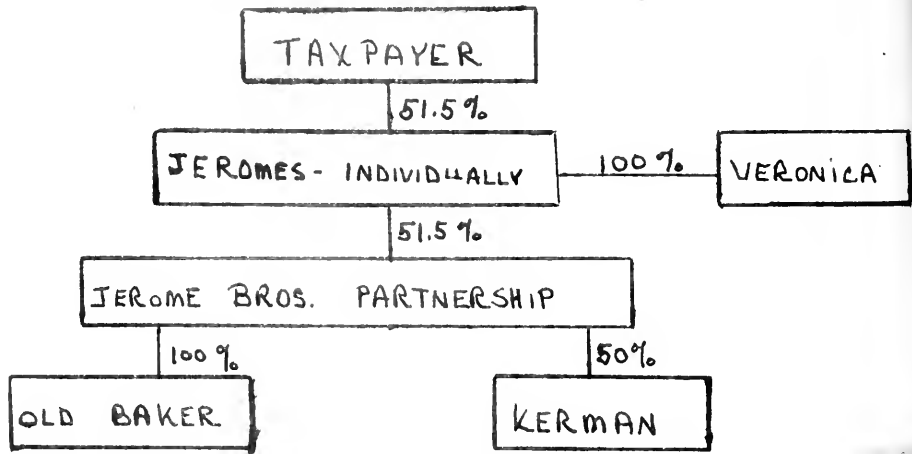
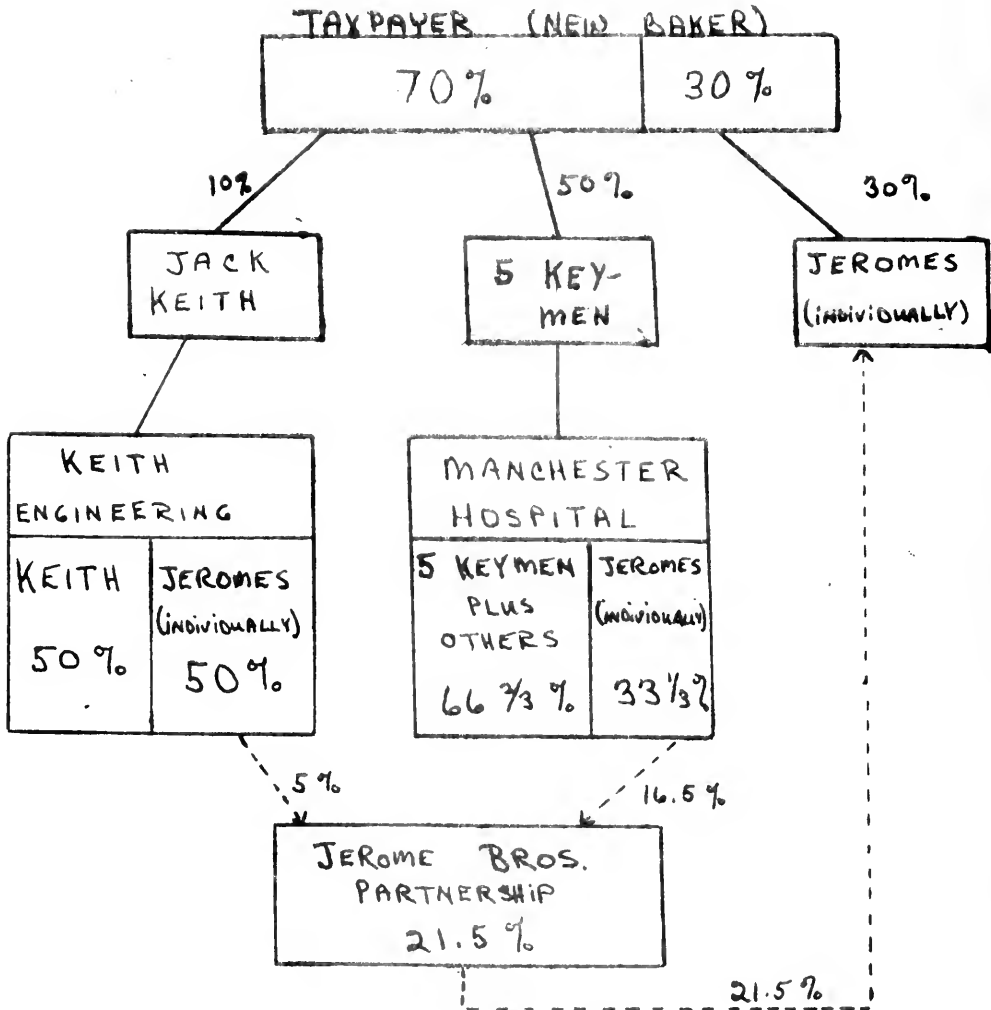
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* * * * *

(26 C.F.R., Sec. 1.708-1.)

APPENDIX B



No. 23019

FEB 24 1963

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

BAKER COMMODITIES, INC., a California Corporation,
Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

On Petition for Review of the Decision of the Tax Court
of the United States.

REPLY BRIEF FOR APPELLANT.

HILL, FARRER & BURRILL,
GILLIN & SCOTT,
CARL A. STUTSMAN, JR.,
JACK R. WHITE,
GLENN M. ALPERSTEIN,

FILED

FEB 11 1963

445 South Figueroa Street, WM. B. LUCK, CLERK
Los Angeles, Calif. 90017,

Attorneys for Appellant.

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BAKER COMMODITIES, INC., a California Corporation,
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vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

On Petition for Review of the Decision of the Tax Court
of the United States.

REPLY BRIEF FOR APPELLANT.

Preliminary Statement.

A comparison of appellee's brief with that filed previously by appellant will disclose immediately that the parties have taken substantially different approaches to the issues raised by this appeal. We feel that one particular aspect of this difference in approach requires some preliminary comment before we address ourselves to appellee's specific arguments.

Appellant contends that the trial court misconstrued the meaning and purpose of the statutory provisions involved herein, ignoring controlling judicial interpretations. Appellee does not even attempt to meet most of appellant's legal arguments, but instead treats the ques-

tions presented as if they involve determinations of fact, governed on appeal by the “clearly erroneous” rule.

The presumption in favor of the trier of fact under the “clearly erroneous” rule has no application here. Although some of the issues presented have been called questions of fact, an examination of the relevant cases shows that such characterization merely means that the result turns upon a determination of certain critical facts which are generally a matter of dispute. But in the instant case, appellant does not question the Tax Court’s determination of the facts; appellant’s arguments are directed solely at the *conclusions* which the court drew from its findings with respect to the applicability of the statutes in question. This is strictly a matter of applying the correct principles of law to an uncontroverted set of facts. Whether the conclusions thus required are labeled as questions of fact or law or “mixed” questions is immaterial. The point is, the trial court misapplied the law to the facts and this court is not in any way bound by that kind of error.

ARGUMENT.

I.

Appellee Failed to Refute Appellant's Arguments That the Trial Court's Findings and Uncontroverted Evidence, as a Matter of Law, Compelled the Conclusion That the June 26, 1961 Transaction Was a Purchase and Sale, Not Governed by Section 351.

A. Appellee, Like the Trial Court, Ignores Completely the Real Purposes of the Code Provisions in Issue; and Although Appellee's Interpretation Differs From the Trial Court's, Both Are Equally Irrelevant to the Statutory Objectives.

The ultimate question presented is whether appellant's acquisition of the stock of two subsidiary corporations, herein called "Old Baker and Kerman," was by "purchase" as that term is defined in section 334(b)(2) of the Internal Revenue Code of 1954. If so, since appellant immediately liquidated those corporations to acquire their assets, section 334(b)(2) provides appellant's tax basis for such assets is equal to the cost of the purchased stock. As we demonstrated in our opening brief, the trial court erroneously held that the stock was not "purchased" on the ground that the June 26, 1961 transaction fell within the mechanical provisions governing non-taxable "exchanges" under section 351, which exchanges are excluded from the statutory definition of "purchase" in section 334(b)-(3)(B).

In defending the trial court's determination, appellee argues initially to the effect that section 334(b)(2) is an exception to the general rule and therefore the strict requirements of that statute must be met in order to obtain its benefits—implying that the section involves a special privilege of limited application. (Appellee's

Br. pp. 21-25.) This assertion is inaccurate, however, and ignores the real purposes of the statute.

The general rule is that a taxpayer's basis for an asset acquired by purchase is the *cost* of such asset. Int. Rev. Code §1012. The very purpose of section 334(b)(2) is to apply that same rule to situations where a corporation acquires assets by purchasing the stock of another corporation and then liquidating it. In such case, the transaction is really a purchase of assets. But because it takes the form of a stock purchase and liquidation, it would be governed by the rule applying to normal parent-subsidary liquidations, if it were not for section 334(b)(2), and would require a carryover basis for the assets received by the parent. Hence, although the basis computed by reference to the price paid for the stock, under section 334(b)(2), is generally called a "stepped-up" basis (*i.e.*, an increase over the depreciated basis of the former corporation), it is not really a special privilege or benefit. It is simply a statutory recognition of the fundamental principle that the substance rather than the form of a transaction controls the incidence of taxation. The acquiring corporation does not lose its just and proper cost basis for the assets purchased in this fashion merely because, for business reasons or convenience, the transaction was cast in the form of a purchase of stock and liquidation.

We submit that there is no question but that appellant met the strict requirements of section 334(b)(2) and did precisely what the statute contemplated. Appellant acquired 100% of the stock of Old Baker and Kerman (along with two other corporations) on June 26, 1961, pursuant to an "Agreement of Purchase and Sale," and paid a total price of \$3,462,500 in the form of promissory notes to the two sellers, the Jerome Brothers Partnership and R. S. Wilson Co. Appellant then

immediately liquidated Old Baker and Kerman and allocated the purchase price to the assets. The trial court found that the price had been negotiated at arms length and was fair. It is indisputable that appellant would have been entitled to a basis measured by the purchase price if it had purchased the assets directly. The purpose of section 334(b)(2) is to give appellant this fundamental right where the purchase was carried out in a different form but with the same economic and substantive effect.

The reason for excluding section 351 transactions from the definition of the term "purchase" in section 334(b)(2) is consistent with the overall purpose discussed above. As we pointed out in our opening brief, the basic premise which underlies a section 351 transaction is that there is a mere change in the form of the transferor's investment in the transferred property, rather than a disposition of such property to "cash in" such investment. (See Appellant's Br. pp. 25-28.) In such situations, there should be no change in basis. Hence, section 362 of the Code requires that the controlled transferee corporation must carry over the transferor's basis for the property thus acquired. The exclusion of section 351 transfers from the provisions of section 334(b)(2) achieves the same result where the transferred property consists of stock in another corporation which is then liquidated.

By contrast, a true sale of assets is always more than a mere change in the form of an investment. There is a transfer of ownership to a new entity in exchange for payment of an agreed consideration to the former owner. Even where payment of the purchase price is deferred over a period of years, with appropriate security provisions, it represents the interest of a *creditor* as distinguished from that of a *proprietor*.

When payment is complete, the seller has “cashed in” his investment. Hence, it has long been settled that bona fide deferred payment sales to corporations, even when they are controlled by the seller through stock ownership, do not fall within the meaning or purpose of section 351. They are to be treated as ordinary taxable events, the same as all other sales; the seller realizes gain and the buyer acquires a new basis equal to his cost.

A fortiori, a sale of stock to a corporation *controlled by someone other than the seller*, designed to effect an acquisition of assets through a section 334-(b)(2) liquidation, does not satisfy the purposes of either that section or section 351, and to apply them would unjustly deprive the new corporate and beneficial owners of their rightful cost basis for the assets purchased and paid for.

Nevertheless, without discussing or considering the statutory purposes, the trial court concluded that the June 26, 1961 transaction fell within the terms of section 351, applied mechanically, and hence appellant could not compute its basis under section 334(b)(2). In an approach which must be a classic example of seeing the trees but never the forest, the court first determined that the promissory notes received by both the Jerome brothers and Wilson Co. for the purchase price could be regarded as “securities”; then the court said the only question was whether the transferors who received such “securities” were in “control” of appellant, and determined that they had the necessary, 80% stock ownership by viewing the sales as part of a “single transaction” along with the prior issuance of appellant’s stock. [T. 140-147.] The court ignored completely the significance of the fact that 70% of such stock went to seven individuals who were not previous owners, and that one of the sellers, the Wilson Co., received no stock at all.

Appellee, while varying the emphasis, was equally arbitrary and oblivious to the statutory purposes. Appellee contends that the question of whether section 351 applies depends first upon a determination of whether the Jeromes (but not the Wilson Co.) and the other 70% owners of appellant constituted a “transferor group” in control of appellant “immediately after the exchange,” under the single transaction theory. If so, appellee would find that section 351 applied regardless of whether the note received by the Jeromes was a security. Appellee suggests that if the note was not a security and was regarded as the equivalent of cash, it would be treated as “boot” under section 351(b). (Appellee’s Br. pp. 26-30.) However, appellee then argues that the trial court correctly concluded the note received by the Jeromes was a security, though apparently conceding the court was mistaken as to the Wilson note. (Appellee’s Br. pp. 29-35.)

Because they did not relate their respective rationales to the statutory purposes, both appellee and the trial court misinterpreted the law and failed to properly analyze the uncontroverted facts of this case. This not only resulted in their equally untenable positions, it produced the somewhat anomalous phenomenon of an appellee tacitly conceding that the trial court’s rationale was wrong but nevertheless defending its decision with arguments that are contrary to the court’s findings.

B. Appellee Erroneously Argues That the “Single Transaction” Doctrine Justifies the Trial Court’s Holding That the June 26, 1961 “Sale” by the Jeromes Was Governed by Section 351.

Appellee argues at length that the evidence supports the trial court’s finding that the issuance of appellant’s stock and the June 26, 1961 transfer of property by

the Jeromes “are to be viewed as steps in a single transaction.” (Appellee’s Br. pp. 26-29.) This totally begs the question and affords appellee a straw man.

We do not contend that the June 26, 1961 sale by the Jeromes and R. S. Wilson Co. was an “isolated transaction,” having no relation to the issuance of appellant’s stock as appellee suggests. (Appellee’s Br. pp. 22-23.) Certainly, appellant was activated for the purpose of purchasing the various assets in question so that it could carry on—under 70% new ownership—the businesses formerly carried on by the Jeromes and Wilson Co. *The real issue is whether the transfer by the Jeromes was a bona fide sale. If it was a sale, as we contend, it would not have been covered by section 351 even if it was carried out simultaneously with the issuance of stock.* See *Charles E. Curry*, 43 T.C. 667 (1965) and *Stevens Pass, Inc.*, 48 T.C. 532 (1967), discussed at length in our opening brief.

Contrary to the suggestion in appellee’s brief, the trial court did not find that the June 26, 1961 transaction was not a bona fide sale. On the contrary, it is implicit in the court’s findings that a bona fide sale—at least in the economic sense—was intended and actually occurred. The court simply believed it could not be treated as a “sale” for tax purposes because the length of term and protective provisions of the notes for the purchase price made them “securities,” bringing the transaction within the purview of section 351. This is strictly a question of statutory construction.

In other words, as the court viewed it, section 351 is mandatory and must be applied, irrespective of the parties’ intent, solely because appellant’s obligation to pay for the purchased assets was represented by “securities,” rather than cash or short term notes. In reality, the fact that the court also found a “single transac-

tion” involving the sales and stock issuance, was nothing more than a secondary consideration involving the “control” requirement of the statute. Conceptually, it had nothing to do with the court’s initial but erroneous determination that the transaction was a transfer in exchange for securities.¹

Appellee ignores the trial court’s actual rationale, however, and argues that the court “concluded that the transaction was not a purchase and sale, but in reality and substance part of a plan of forming and financing a corporation.” (Appellee’s Br. p. 22.) As we have shown, and as the record plainly indicates, this is not what the court concluded at all. The court absolutely did not find that the transaction was not in substance a sale and could not have done so under the uncontroverted evidence. Thus, appellee’s entire “single transaction” argument is not only different from the court’s rationale, it is based upon a hypothesis which has no basis in the findings or record.

Nor is there anything in the principles which underlie the “step-transaction” doctrine which would convert a true sale into a section 351 exchange. All that doctrine means is that a *purported sale* which is in fact a transfer in exchange for stock or securities, cannot avoid the impact of section 351 through the device of labeling it a sale and having it occur before or after the issuance of the stock or securities.

A mere glance at the step-transaction cases referred to by appellee as “involving facts quite similar to the

¹While we agree that the section is not “optional,” we insist that the court missed the point. A true sale—which depends upon the parties’ intent—does not come within reach of the statute at all. Whether or not the purchase price is paid in a form which might be regarded as a “security” is immaterial. The facts of the *Curry* and *Stevens Pass* cases are indistinguishable and conclusively refute the trial court’s holding here, *as a matter of law*.

instant case" (Appellee's Br. p. 28) will reveal immediately that they are totally inapposite. Not one of them involved a situation even remotely like the one present here. Most of them involved transfers solely in exchange for stock and the question was whether they were covered by the statute even though they occurred on different dates. In each case, since the transfers fell squarely within the statutory purpose of effectuating a mere change in the form of the transferor's investment, they were held to be "single transactions" covered by the non-taxable exchange provisions. Such cases in no way support appellee's position in this case.²

It is apparent that appellee's misapplication of the step-transaction doctrine to the facts of this case is the result of a fundamental misunderstanding of the principles governing section 351 itself. In essence, appellee seems to believe there can be no such thing as a sale of a going business to a new corporation by one who also acquires some of its stock. Appellee repeatedly talks about a plan of "forming and financing a corporation" (Appellee's Br. pp. 22, 29, 39) and as-

²*Houck v. Hinds*, 215 F. 2d 673 (10th Cir. 1952), one of the "step transaction" cases cited by appellee, involved an attempted "sale" which became a non-taxable exchange, but under unique facts which have no relevance here. A partnership transferred partnership assets to a corporation in exchange for promissory notes. Originally, the corporation was to be owned by a third party but he promptly sold out and all of the stock was issued to the former partners. The court held the entire transaction resulted in a non-taxable exchange and treated payments on the corporate notes as ordinary dividends—indicating that the notes were regarded as a form of stock, rather than as a bona fide indebtedness. Although some question might be raised as to the soundness of some of the court's reasoning, *Houck v. Hinds* has no application here for obvious reasons. Here notes for the purchase price were found to be bona fide indebtednesses, not stock. Furthermore, that case was expressly distinguished in *Stevens Pass, Inc.*, 48 T.C. 532 (1967) for precisely the same reason it is distinguishable here: there was no *change in ownership* to take the case outside the purview of the statute.

serts that section 351 cannot be avoided by affixing to such transaction the label "sale." (Appellee's Br. pp. 19, 28-29, 30-31.) Yet, appellee apparently concedes (disagreeing with the Tax Court) that the Wilson Co.'s transfer to appellant, *as part of the very same transaction*, was a sale, not covered by section 351, because the "seller" received no stock in appellant. (Appellee's Br. pp. 27, n. 12, 34 n. 19.) In other words, appellee urges that treatment of the Jeromes' transfer as a sale is precluded solely because they "retained for themselves a highly significant degree of participation in and control over the affairs of the taxpayer-corporation in its operation of the business purportedly 'sold' to it." (Appellee's Br. p. 30.)

Appellee makes no attempt to reconcile this theory with the many cases we cited in our opening brief, in which transfers were held to be excluded from section 351 because they were sales, even though the sellers owned *all* of the purchasing corporations' stock and the corporations were formed for the purpose of making such purchases. See, *e.g.*, *Miller's Estate v. Commissioner*, 239 F. 2d 729 (9th Cir. 1956); *Murphy Logging Co. v. United States*, 378 F. 2d 222 (9th Cir. 1967); *Sun Properties, Inc. v. United States*, 220 F. 2d 171 (5th Cir. 1955); *Henry F. Shannon*, 29 T.C. 702 (1958); *Warren H. Brown*, 27 T.C. 27 (1956), *acq.*, 1957-2 C.B. 4. Additional cases are cited on page 30 of our opening brief.

Furthermore, as we have repeatedly emphasized because of its importance, our case presents an even stronger case than those involving sales to corporations wholly owned by the sellers, because the Jeromes owned only 30% of appellant's stock. Hence, the principal purpose and actual effect of the transaction was to shift 70% of the beneficial ownership and voting control to

seven key employees who did not previously have any proprietary interest in the business. This substantial shift in proprietary interest must, as a matter of law, be regarded as a sale falling outside the coverage of section 351, even if it is deemed part of the overall transaction of "forming and financing" appellant. The cases of *Charles E. Curry, supra* and *Stevens Pass, Inc., supra*, expressly rejected appellee's single transaction theory because of changes in ownership which were less pronounced than this.

Appellee totally ignores this change in ownership and voting control and even goes so far as to attempt to materially distort the trial court's findings by using sweeping generalities to describe the alleged "highly significant degree of participation in and control over the affairs of" appellant. Appellee repeatedly states that the Jeromes "dominated" appellant; that they "retained extensive and highly restrictive controls" over appellant and were "heavily involved" in management. (Appellee's Br. pp. 18-19, 38-39.) Appellee also suggests that the Jeromes "did not want to sell or 'cash-in' their various interests . . . but instead to merely lay the foundation for a perpetuation of their business by their employees after they retired." (Appellee's Br. p. 18.) *All of this is squarely contrary to the trial court's findings.*³

What the court actually found is that the Jeromes "agreed to sell" their partnership assets to appellant for the purpose of perpetuating their business, knowing that there would be an *immediate loss of control* be-

³Appellee's reference to the fact that the Jeromes and keymen had the same management positions after the transaction as before is also misleading in light of the findings. While their *titles* may have been the same, the court's findings and the evidence showed a decided shift in actual responsibility to the keymen after they acquired their proprietary interests.

cause they would be reduced to a minority voting position. [T. 93, 109, 135-136.] The court expressly stated:

“Correspondingly, we do not interpret the multitude of facts surrounding the transaction as indicating an attempt by the Jerome Brothers to transfer the business while, at the same time, retaining control thereof. In support of this interpretation, we note that subsequent to the transaction, not only were the brothers’ minority stockholders, but they actually assumed less responsibility in the company’s management while the key-men assumed increasingly more.” [T. 132.]

As for the “restrictions” imposed upon appellant by the Agreement of Purchase and Sale for the duration the purchase obligation remained outstanding, the court correctly observed that their purpose was to protect the Jerome Brothers Partnership, as a creditor, from indiscriminate acts of management which might severely affect appellant’s ability to make timely payments on the note. Moreover, the court said it was significant that “those restrictions are not of a nature which would permit the Jerome Brothers to bind the corporation whenever and however desired.” [T. 134-135.]⁴

Accordingly, finding just the opposite of what appellee represents, the court concluded:

“We search the record in vain for any significant evidence which might suggest that the brothers intended to retain effective control over New Baker after the 1961 transaction. Subsequent to June, 1961, the key men assumed more responsibility

⁴The creditors’ “controls” were strictly of a limited and negative nature, imposing restrictions of a type to be expected in any long-term sale on credit. They would not affect appellant’s operations in the ordinary course of its business. Exactly the same “controls” were provided for in the Wilson Co.’s agreement with appellant—which appellee concedes was a sale.

and control over the affairs of New Baker's business while the brothers, especially Frank, assumed less. . . . In fact, the company enjoyed its greatest financial success in the period subsequent to June, 1961, under the increasing direction and control of the keymen." [T. 135-136.]

In the final analysis, appellee's "single transaction" argument is a thinly disguised second effort to prevail under its original "sham transaction" theory which was expressly rejected by the trial court. Every one of the arguments appellee advances now was advanced below in support of the contention that the alleged sale was a sham, that the Jeromes retained actual control of appellant, and in substance the note they received represented an equity interest rather than that of a creditor. This court is respectfully referred to the Tax Court's thorough disposition of these discredited arguments in the opinion below. [T. 125-137.]

C. Appellee Misstates the Law and Completely Fails to Meet Appellant's Contention That the Installment Note to the Jeromes Was Not a "Security" Within the Purview of Section 351.

As stated previously, the sole basis for the trial court's decision that section 351 applied to the June 26, 1961 transaction was the court's conclusion that the installment notes received by *both* the Jeromes and R. S. Wilson Co. constituted "securities." [T. 140-143.] In our opening brief we demonstrated that this conclusion was the result of a misunderstanding of the meaning and purpose of that term as it is used in section 351. A corporate obligation given in exchange for a transfer of property constitutes a security within the meaning of the organization and reorganization provisions of the Code only where it provides the trans-

feror with a continuing stake in the business of the corporation, amounting to a proprietary interest. We cited numerous decisions holding that a long-term installment obligation given as the purchase price in a bona fide sale to the corporation does not provide the requisite continuing proprietary interest, but creates only a debtor-creditor relationship.⁵ Hence, such obligation is not a security within the purview of section 351.

Although appellee also argues that the Jeromes' note was a security, appellee's entire rationale and interpretation of section 351 is quite different from that of the trial court. In the preceding discussion, we pointed out that appellee mistakenly believes section 351 would apply to the Jeromes' sale to appellant under the "step transaction" doctrine regardless of whether the note was a security. (Appellee's Br. pp. 29-30.) As appellee sees it, the key factor is that the Jeromes retained stock in appellant. This provides the excuse for combining the sale and stock issuance into a "single transaction" under section 351—disregarding, of course, the economic effect of the transaction and statutory purpose. Appellee also uses the fact of stock ownership to defend the Tax Court's decision that the Jeromes' note was a security. *But at the same time, appellee apparently concedes the court was wrong in concluding that the note received by the Wilson Co. was a security, because Wilson received no stock.* (Appellee's Br. p. 34.)

Appellee tries to brush aside the trial court's holding that the Wilson note was a security, suggesting that it is of no importance because it was not necessary to include Wilson's 50% of the Kerman stock in the section 351 transaction to disqualify the "purchase" of all of Kerman's stock under section 334(b)(3)(B).

⁵See, e.g. *Le Tulle v. Scofield*, 308 U.S. 415 (1940).

Disqualifying the Jeromes' 50% was enough to do the job. But the significance of this dichotomy in reasoning between appellee and the trial court with respect to the treatment of the Wilson Co. cannot be ignored. Indeed, it illustrates graphically that neither appellee nor the trial court really understood the purpose and scope of section 351 or the meaning of the term securities.

The trial court believed that both notes (which contained substantially identical terms) constituted securities because of their 15-year length and their restrictive "security provisions." The court said these factors gave the noteholders "a continuing interest in the business." Hence, it concluded both the Jeromes and Wilson Co. had made section 351 transfers in exchange for securities. Although the court mentioned the retention of stock by the Jeromes as an additional factor, it was clearly not controlling in the court's thinking because admittedly the Wilson Co. did not retain any stock.

Appellee, on the other hand, places its emphasis on stock ownership rather than the notes themselves. Hence, it is argued that the Jeromes had a continuing proprietary interest in the business *from their stock ownership*, and therefore their note is a security; but because the Wilson Co. did not retain any stock, it did not have a proprietary interest in appellant and its note was not a security. Thus, appellee concludes that although they made simultaneous transfers as part of the same transaction under virtually the same agreements of purchase and sale, receiving installment notes identical except as to face amount, Wilson's transfer was a sale and the Jeromes' was not. (Appellee's Br. p. 34.)

Implicit in this argument is appellee's concession that the notes by themselves do not constitute securities because they do not provide a continuing proprietary in-

terest in appellant's affairs. Hence, appellee, in effect, agrees with us that the trial court's emphasis on the term of the notes and protective provisions as supplying the necessary continuity of interest was erroneous.⁶ Accordingly, when appellee asserts that the evidence supports the finding of "a continuing stake in the business" on the part of the Jeromes, appellee is not even talking about the same "security interest" contemplated by the trial court.

It requires only minimal research and analysis to see that appellee's interpretation of the law is just as incorrect as the trial court's. Appellee states, without any citation of authority, that the requisite proprietary interest "need not be exercised through the 'securities'" (Appellee's Br. p. 32); and "there is no requirement that the security itself be in the nature of a proprietary interest, so long as the transferor retains *some* continuing stake and degree of participation in the transferee corporation beyond that of a mere creditor." (Appellee's Br. p. 34.) In other words, it is not the term or even the provisions of the note itself which

⁶Although appellee does not deny that a continued proprietary interest is necessary for section 351 to apply, appellee offers a very confusing *non sequitur* that the continuity of interest requirement in a "security" is somehow of "less significance" here than it was in *Cortland Specialty Co. v. Commissioner*, 60 F. 2d 937 (2d Cir. 1932) and *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933), because of a 1934 change in the statutory definition of "reorganization." Appellee also seems to imply from his selective quotations from those cases that it is only "short-term purchase-money notes" which fail to meet the requirement. (Appellee's Br. pp. 32-34.) This entire point is conclusively disposed of by reference to *Le Tulle v. Scofield*, 308 U.S. 415 (1940), which we discussed at length in our opening brief but appellee seems to have overlooked. That case expressly held that *Cortland* and *Pinellas* were not limited to short-term notes; and that *longterm* purchase obligations given in connection with a bona fide sale were not "securities" because they did not give the creditor a continuing proprietary interest as contemplated by the non-taxable exchange provisions in connection with corporate reorganizations.

make it a "security" in appellee's view, but rather the fact there was a proprietary interest *independent of the note* through retention by each of the Jeromes of 10% of appellant's stock. Appellee's rationale would apply with equal effect to a transaction in which a "seller" receives only one share of stock and 1,000 or more shares are issued to outsiders who invest cash. In other words, it becomes virtually impossible for an individual to make a sale of business assets to a newly formed corporation if he receives any stock interest, no matter how small.⁷

Appellee's belief that *mere stock ownership* in the purchasing corporation by the seller can convert a bona fide obligation for the purchase price into a "security" within the purview of section 351, is absolutely contrary to the law, not to mention common sense. We wish appellee had seen fit to explain how it is that so many of the cases which we discussed in our opening brief held deferred payment sales to newly formed corporations, *owned entirely by the sellers*, were not covered by section 351. (Appellant's Br. pp. 30-32.)

For example, in *Warren H. Brown*, 27 T.C. 27 (1956), in which the Commissioner acquiesced in 1957-2 C.B. 4, the Tax Court held a transfer of partnership assets to a newly formed corporation, owned entirely by the partners, in exchange for ten-year installment notes, was a bona fide sale not covered by section 351. The court expressly ruled that the notes were not securities because they did not give the sellers a continued participation in the business; they simply rep-

⁷As we saw in appellee's "step transaction" argument, appellee urges that Jeromes' "sale" is governed by section 351 even if, instead of a "security," they are deemed to have received "cash or its equivalent." (Appellee's Br. p. 30.) There is simply no room in appellee's theory for a sale *on any terms* to a newly formed corporation, if the seller owns some of its stock.

resented creditors' interests. Hence, the court correctly recognized that the "continued proprietary interest" which is required of a security *must come from the security itself, rather than stock ownership*. Appellee's argument to distinguish *Brown*, that the transfer involved only part of the partnership business, whereas the Jeromes transferred all of their business, is patently irrelevant; and the rest of appellee's argument simply assumes the very point in issue. (Appellee's Br. p. 37.)

Two other cases in point cited in our opening brief, which appellee chose not to discuss, are *Harry F. Shannon*, 29 T.C. 702 (1958) and *Arthur F. Brook*, T.C. Memo 1964-285, 23 T.C.M. 1730, *rev'd on other grounds*, 360 F. 2d 1011 (2d Cir. 1966). Both held installment notes received from corporations, formed to acquire the sellers' business assets, represented true sales and were not securities within the contemplation of section 351 or its forerunner under the 1939 Code, despite the simultaneous acquisition of stock ownership and control on the part of the sellers. In *Shannon*, the sellers owned all of the purchasing corporation's stock and in *Brook* the seller owned 60% of the stock. The following language from *Brook* (at p. 1739) flatly refutes appellee's position in the instant case:

"The only investment Brook had in petitioner was his stock. Petitioner's installment obligation was not intended to give Brook a continuing investment or stake in petitioner's business. On the contrary, the purpose of the contract was to liquidate, as quickly as was consistent with petitioner's business and financial exigencies, all of Brook's interest, other than that arising in connection with his stock ownership, in petitioner's economic well-being. Therefore, petitioner's contractual obligation to pay Brook for the franchise is not a security within the meaning of section 351."

Appellee is also wide of the mark in attempting to distinguish *Charles E. Curry, supra*, and *Stevens Pass, Inc., supra*, which are even closer to the instant case and present the most compelling reasons for rejecting appellee's position, as well as that of the trial court. Appellee says that in *Curry* the sellers "ceased to have a continuing stake in the affairs of the transferee corporation that in any way approached that of the Jeromes." (Appellee's Br. p. 38.) Appellee did not read the facts of that case very carefully. Two of the four sellers there, a father and son, retained 55% of the stock, giving them *voting control* in the new corporation. The remaining 45% of the stock was owned by the husband of a third seller. All of the sellers were members of the same family. In the instant case, by contrast, none of the Jeromes had over 10% of the new corporation and collectively they had only 30%—far short of voting control. Moreover, as part of the same transaction here, one seller, the Wilson Co., cashed in completely, just as two of the sellers did in *Curry*. But the overall shift in ownership here was even greater than in *Curry*, since 70% of the enterprise passed to entirely new owners who were not relatives of the sellers.

With respect to *Stevens Pass, Inc.*, appellee merely states that the corporation was formed because of an "irreparable dispute" between two of the owners of the former enterprise which led them to solicit outside investors for a new corporation to which they would "sell out" their interests; that one of the sellers did not receive any stock in the new corporation; and that the new corporation was "dominated by the outside investors." (Appellee's Br. p. 38.) But how is this materially different from the instant case? The fact that here there was a different, but equally legitimate, business motive for selling to a corporation controlled by individuals who had no prior ownership interest, is cer-

tainly not a material distinction. And, like *Stevens Pass, Inc.*, one of the sellers here (owning 50% of two of the transferred corporations) sold out without receiving any stock in appellant. But the most important point of all, once again, is the fact that here the Jeromes had only 30% of appellant, whereas in *Stevens Pass, Inc.*, two of the sellers retained an aggregate of 50% of the new corporation, thereby depriving the outside investors of voting control.

Aside from being totally irrelevant under the cases, appellee's continued use of generalities to the effect that the Jeromes "dominated" and "controlled" appellant, as justification for the court's conclusion that the Jeromes' note was a security (Appellee's Br. pp. 36-40), has already been exposed as contrary to the court's findings and the record. Appellee simply refuses to accept the trial court's pivotal finding that a majority of the beneficial ownership and actual control passed to the seven keymen as the result of the June 26, 1961 transaction.

To sum up, we submit that the 70% change in ownership, along with the court's extensive findings establishing the bona fide character of the transaction, compel a reversal on this issue. Neither appellee nor the trial court cite a single case, and we are confident there are none, where section 351 has been applied to a transaction involving *any* substantial change in ownership. Moreover, *Charles E. Curry* and *Stevens Pass, Inc.*, which cannot be distinguished, expressly held that lesser changes than what we have here conclusively precluded application of the statute. Those cases are cogently reasoned to effectuate the purposes of the statute and definitely should be followed in this case.

II.

Appellee Failed to Refute Appellant's Arguments That the Trial Court Erred in Its Interpretation of the Constructive Ownership Rules of Section 318, Thereby Denying Appellant a Stepped-Up Basis in Connection With Both the 1961 and 1962 Transactions.

This issue, to a certain extent, overlaps with the first issue involving section 351. As an alternative ground for holding that the June 26, 1961 purchase and sale did not qualify for a stepped-up basis under section 334(b)(2), the Tax Court held that the stock owned by the Jeromes in the corporations acquired by appellant was attributable to appellant under the constructive ownership rules of section 318. Stock attributable from a seller to a buyer cannot be "purchased" under the statutory definition of that term in section 334(b)(3) (C). On the same ground, the court held that appellant's December 20, 1962 purchase of the Jeromes' stock of a Panamanian corporation, herein called "veronica," did not qualify for treatment under section 334(b)(2).

The manner in which this result was brought about, through an involved compounding of several different constructive ownership rules, is described in our opening brief. In essence, the court's interpretation of section 318 treats the Jeromes, who actually owned only 30% of appellant's stock, as if they owned 51.5%, barely nudging them over the fatal 50% required to bar the application of section 334(b)(2) to any purchase of stock from the Jeromes by appellant.

The vital link in the court's chain of attribution was supplied by a certain limited partnership, herein called "Manchester." Although the court found Manchester sold all of its assets and ceased to engage in business

prior to either the 1961 or 1962 transactions, the court nevertheless concluded Manchester remained an existing “partnership” within the meaning and contemplation of section 318, for purposes of treating its former partners as the owners of each other’s stock in appellant. The court found that Manchester continued to collect some of the proceeds from the March 1, 1961 installment sale of its entire assets and reported such collections in a “final partnership return” for the period ending August 31, 1962; the return also showed that a small balance on the sale price remained outstanding as of August 31, 1962. It was further found that no formal dissolution papers were filed for Manchester. [T. 152-154.] On these findings, the court concluded:

“Inasmuch as the partnership continued to exist, at least for the purpose of receiving the unpaid balance on the promissory note, we must reject petitioners’ contention and hold that on December 20, 1962, Manchester Medical Hospital was still winding up its corporate (*sic*) affairs and therefore was in existence for the purpose of applying the attribution rules of section 318(a).” [T. 152-154]⁸

⁸Appellee’s renewed attempt to rely on the existence of another alleged partnership, American Extraction Co., as an alternate to Manchester to supply the necessary attribution (Appellee’s Br. p. 44, n. 24), is entirely improper. Appellee urged below that American remained in existence after it ceased to transact business and turned over its remaining assets to “Old Baker” in 1960, but the trial court refused to make any such finding of continued existence by American. Although the court’s findings recite the facts concerning American, they do not express the date when the partnership terminated [T. 115-118.]; it is abundantly clear, however, that the court did not regard that partnership as being in existence for section 318 purposes since it is not even mentioned in the court’s discussion of the attribution issue in its opinion. [T. 148, 151-156.]

Moreover, the court’s rationale in dealing with Manchester shows that American was not considered to be in existence at
(This footnote is continued on the next page)

No reason was offered by the court, and none is suggested by appellee, as to why Manchester was found to have remained in existence after August 31, the closing date of its "final return."

As we pointed out in our opening brief, this is entirely a question of statutory interpretation and a matter of first impression before the appellate courts. The only other case to even consider the question of when a partnership ceases to be such under section 318 was *J. Milton Sorem*, 40 T.C. 206 (1963), *rev'd on other grounds*, 334 F. 2d 275 (10th Cir. 1964), on which both the trial court and appellee rely. There, the Tax Court, in an opinion by the same judge who wrote the opinion in the instant case, gave the question no more than passing comment in a footnote; and the Tenth Circuit Court of Appeals, reversing for other reasons, did not mention it at all. Furthermore, while we believe *Sorem* was inadequately reasoned and wrongly decided by the Tax Court on this point, the case is distinguishable. There, the taxpayer *admitted* that the partnership continued in existence and continued to collect and pay various accounts which had been created by *ordinary business operations* of the partnership. Hence, *Sorem* involved a very different type of "winding up" activity from that found here—where there was merely

the time of either the 1961 or 1962 transactions because, although American was not terminated by any formal documentation, it did not collect any money or file any tax returns after 1960. Contrary to appellee's assertion (Appellee's Br. p. 17), the proceeds of the 1961 sale by appellant of the inventory acquired from American were paid to the former partners in their *individual capacities*. The court expressly found:

"The last partnership income tax return for American was filed for the calendar year 1960. Those individuals *who had been partners* in American reported income received from the 1961 disposition of American's inventory *on their individual income tax returns* for that year." (Emphasis added.) [T. 117.]

a partnership tax return reporting collections on the installment note from the very sale of the partnership's entire assets which we contend dissolved the partnership under state law, and terminated it for partnership taxation purposes under the Internal Revenue Code.

It is our contention that the statutory purposes behind sections 318 and 334(b)(3)(C) compel a different conclusion on this issue than that reached by the court below. The court and appellee failed to reconcile their positions with those purposes, just as they did with respect to the section 351 issue. So far as they are concerned, if a partnership, which has admittedly ceased to carry on the venture for which it was organized, nevertheless can be deemed to remain in existence *for any purpose*, no matter how limited, it is sufficient to spring the trap in section 318 if any of the partners subsequently deal in stock in another unrelated venture. Under the undisputed facts of the instant case, this blind obedience to the strict letter of the statute, as they interpret it, means that an irrelevant technicality would deprive appellant of its fundamental right to use cost to determine the tax basis for assets which it admittedly must pay for. Worse yet, the technicality is *pure fiction* as applied here, and exalts form over substance to its most absurd limit. It has the effect of conclusively presuming the transactions to be not at arms length because of the sellers' "constructive control" over the buyer—despite actual findings by the court that the sellers did not control the buyer, that the transactions were entirely at arms length and the prices paid were fair.

The point we are trying to make is simply that the term "partnership" in section 318, which is not defined in the statute or regulations, must be given a meaning consistent with the objectives of the statute. Partnership "existence" for attribution purposes cannot be

made to depend upon legal formalities of the type relied upon by the trial court and appellee, which have no relevance to the underlying reasons for constructive ownership, without making a travesty of the statute.

But this is not to say that we concede Manchester “existed” for even a limited purpose after the March 1, 1961 sale of its assets. Appellee misstates our position when he suggests that our contention is “Manchester ceased to engage in an active trade or business on March 1, 1961, and that, although it was not legally dissolved or terminated, it was, therefore, not in existence for purposes of section 318.” On the contrary, we contend that the partnership did legally “dissolve” under California law on March 1, 1961. We further contend, that it “terminated” for purposes of partnership taxation under section 708 of the Internal Revenue Code. (See Appellant’s Br. pp. 45-51.)

Under the California authorities cited in our opening brief, at pages 48-50, “dissolution” (as distinguished from “termination”) is controlled by the parties’ intent and, in the absence of an express agreement to the contrary, is accomplished by *any act or conduct which is inconsistent with the continuance of the partnership*. Obviously, the cessation of business and sale of all partnership assets is such an act or conduct causing dissolution. More important, the legal effect of a dissolution is to *immediately revoke the agency relationship* among the partners as to all subsequent obligations and debts; and it precludes any basis for contending there is beneficial ownership by the partnership or its partners with respect to subsequent unrelated ventures entered into by one or more of the former partners. Hence, since the very foundation of the constructive ownership rules of section 318 is the existence of an agency relationship and presumed beneficial ownership, after Manchester’s dissolution there was absolutely no justi-

fication to apply that section to the subsequent corporate ventures involving appellant's stock, which were in no way connected with the dissolved partnership venture. Manchester no longer "existed" as a partnership within the meaning and contemplation of section 318.

Appellee makes no effort to justify the application of section 318 to a dissolved partnership. Instead, appellee attempts to argue that there was no dissolution, on the unique theory that because the California statute reads that a partnership is dissolved by "any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business," there can only be a dissolution when "one partner ceases to be associated with the venture." (Appellee's Br. p. 46.) In other words, appellee argues a "dissolution" does not include cessation by all of the partners at the same time. Such argument not only lacks authority, it defies common sense.

The two California cases cited by appellee do not in any way support his position. They do not even discuss appellee's "one partner" theory and deal only with the legal effect of a partnership dissolution. Nor are they, or the statutory provisions quoted in appellee's brief, in the least inconsistent with the authorities cited in our brief on the point that the general *agency relationship* between partners ends upon dissolution. They simply mean that after dissolution, if there are any pre-existing obligations to be taken care of, there is a winding up period during which the partnership continues for the limited purpose of settling its affairs; and during any such period, the partners can still act for the partnership as to those pre-existing matters. But this certainly does not mean that the partners have any authority to act as to *new matters*—such as a new corporate venture having absolutely no relevance whatever to the former partnership business or assets, and in-

volving substantially different individuals, as is the case here. Nor does it mean that the partnership necessarily continues after dissolution in even this limited sense, for a “winding up” period, if there are no pre-existing matters to be handled.

Appellee’s sweeping dismissal of all of the California authorities cited by appellant demonstrates the same myopia with which appellee examined the authorities we cited in connection with the section 351 issue. While some of the dissolution cases are indeed “Pre-Uniform Partnership Act,” such fact is quite irrelevant. All of those which were decided before the adoption of the code sections referred to by appellee, were decided under substantially similar earlier code provisions dating back to 1929, and involved generally accepted principles of partnership law which have not changed. In short, the authorities we cited very definitely represent the law of this state at the present time and expressly hold that after dissolution by cessation of business, the agency relationship among the partners ends as to new matters. See, *e.g.*, *Credit Bureau, Inc. v. Beach*, 144 Cal. App. 2d 439, 301 P. 2d 87 (1956); 38 Cal. Jur. 2d., Partnership, §107, pp. 22-23.

With respect to section 708(b) of the Internal Revenue Code, we agree with appellee that the section is applicable expressly only to Subchapter K of the Code, dealing with partnership taxation. (Appellee’s Br. p. 44.) In fact we pointed this out ourselves in our opening brief, and further pointed out that the objectives of section 708 are quite different from those of section 318. There are good reasons to require that a partnership which is still “winding up its affairs” should not “terminate” for partnership taxation purposes, so that it must continue filing tax returns, etc. But such reasons do not justify considering the partnership as still being in existence for purposes of constructive stock

ownership in unrelated ventures. Hence, we contend that even if Manchester could not be deemed “terminated” for partnership taxation purposes under the technical requirements of section 708, it was no longer a “partnership” within the meaning of section 318.

But we nevertheless refer to section 708 because it is clear that Manchester did terminate under that section; and a partnership which no longer exists under Subchapter K can hardly be a “partnership” under section 318. (See discussion in Appellant’s Br. pp. 45-48.) Appellee’s only answer to our section 708 discussion is to state the same patently untenable argument that he made regarding dissolution under California law, that the section only applies to a case where *one partner* terminates, citing no authority. Appellee also says this court’s decision in *Hatch’s Estate v. Commissioner*, 198 F. 2d 26 (9th Cir. 1952), has no relevance because it did not decide when a partnership ceases to exist for tax purposes. (Appellee’s Br. p. 45.) Again, we submit, appellee did not read the case carefully enough. Moreover, appellee declined to comment at all on the significant case of *James, et al. v. United States*, 63-1 U.S.T.C. §9478 (D.C. Ga. 1963), which we cited to demonstrate the relevance of the *Hatch* case to section 708 and the case at bar. (Appellant’s Br. p. 48.)

In essence, *Hatch* and *James* hold that a single sale of substantially all of a partnership’s assets and intent not to continue the partnership’s business constitutes a sale of all of the partners’ “interests” in the partnership’s capital and profits for tax purposes. *Hatch* also indicates that the filing of a partnership tax return for a period after the sale does not mean the partnership was still in existence at that time. But the most important point of all, is that *James expressly holds that a single sale of assets and cessation of business terminates the partnership on the date of the sale under section 708.*

These authorities compel the conclusion that Manchester automatically “terminated” under section 708 on the date of the sale of all its assets, March 1, 1961, notwithstanding the subsequent filing of a tax return reporting collections on the purchaser’s installment note. How can such a partnership still be in existence within the meaning and purpose of section 318?⁹

When this issue is reduced to its fundamental considerations, the question is simply this: Did Congress intend that individuals who were once in a partnership which has been liquidated, should become constructive owners of each other’s stock acquired in a subsequent unrelated venture—for the utterly irrelevant reason that they were still collecting on the installment note given by the purchaser of their partnership venture? Although the trial court so held and appellee so argues, we cannot believe Congress had such an unreasonable and unjust intent.

Finally, even when a partnership does exist for section 318 purposes, the 1964 amendment to that section expressly prohibits multiple reattribution of the same stock as employed by the court here. Contrary to appellee’s assertion, the reattribution process is not, even now, “virtually endless” (Appellees’ Br. p. 48). Section 318(a)(5) now expressly precludes even “double attribution” involving partnerships, as we believe is consistent with Congress’ original intent. See our discussion of the 1964 amendment at pages 52-54 of our opening brief.

⁹It should be noted that all of these same arguments regarding dissolution under state law and termination under section 708 apply with equal effect to American Extraction Co., the other partnership referred to by appellee. As noted previously, however, the court obviously regarded that partnership as terminated because the sale proceeds from the disposition of its assets were reported by the former partners in their *individual returns*, rather than in a partnership return.

Conclusion.

For the reasons stated herein and in our opening brief, we urge that the Judgment must be reversed.

Respectfully submitted,

HILL, FARRER & BURRILL,

GILLIN & SCOTT,

CARL A. STUTSMAN, JR.,

JACK R. WHITE,

GLENN M. ALPERSTEIN,

Attorneys for Appellant.



IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

BAKER COMMODITIES, INC., a California Corporation,
Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

PETITION FOR REHEARING.

HILL, FARRER & BURRILL,
CARL A. STUTSMAN, JR.,
JACK R. WHITE,
445 South Figueroa Street,
Los Angeles, Calif. 90017,

GILLIN & SCOTT,
GLENN M. ALPERSTEIN,
6565 Sunset Boulevard,
Los Angeles, Calif. 90028,
Attorneys for Appellant.

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No. 23019

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

BAKER COMMODITIES, INC., a California Corporation,
Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

PETITION FOR REHEARING.

The appellant herein, Baker Commodities, Inc., respectfully requests that a rehearing be granted in the within matter following the decision of this Court, filed August 8, 1969.

The grounds of the Petition are as follows:

I.

The Court's Construction and Application of Sections 318 and 334(b)(3)(C) of the Internal Revenue Code Cannot Be Reconciled With the Congressional Objectives.

Appellant recognizes that persons for rehearing are rarely granted, notwithstanding the fact that such procedure is theoretically available and appropriate in any case wherein the Court has committed demonstrable error. Nevertheless, appellant seeks such relief in the hope that this Court will reconsider the points urged in this Petition because of the disastrous economic con-

sequences which will otherwise flow from the Court's decision—which consequences, in light of the indisputable facts and the Tax Court's findings, would be totally unjust and unintended by Congress.

In substance, the Court held that Manchester Medical Hospital, a limited partnership, continued to exist as a "partnership" within the meaning of Section 318 of the Internal Revenue Code after it had ceased to operate the sole business for which it was formed and had sold all of its assets on March 1, 1961. Accordingly, some of the "partners" in such partnership were treated as the constructive owners of each other's stock in appellant, acquired after March 1, 1961, in subsequent ventures which were totally unrelated to the partnership venture. Because of such assumed constructive ownership of appellant's stock, Section 334(b)(3)(C) was applied to deny to appellant a new cost basis under Section 334(b)(2), for assets purchased in two separate transactions occurring on June 26, 1961 and December 31, 1962.

Nowhere in the Opinion, however, does the Court discuss the purpose or rationale for constructive stock ownership under Section 318, or the reason that a new basis is denied under Section 334(b)(3)(C), if such constructive ownership is present. Indeed, the Court's interpretation of these Code sections strongly indicates that it either did not understand the statutory objectives or was unconcerned about Congressional intent.

As we attempted to point out in our briefs, the basis on which Congress deemed it necessary to attribute stock owned by a partner to a partnership is that there is a relationship of agency between partner and partnership which arises by law from the nature of the partnership entity. Similarly, the attribution of stock owned by a partnership to its partners in proportion to their

partnership interests, is based upon the principle of beneficial ownership which is inherent in this particular form of legal relationship. These are referred to as the "agency rule" and the "beneficial ownership rule," respectively. We called them to the Court's attention by citing the Congressional Committee Reports in connection with the 1964 amendment eliminating "sidewise attribution" from Section 318. (2 U.S. Code Congressional & Administrative News, 1964, pp. 3401-3404).¹

¹A relevant excerpt from the Committee Reports is as follows:

"To forestall such tax avoidance, the 1954 code contains certain stock 'attribution' rules wherein stock held by a close family member or by a partnership, estate, trust, or corporation in which he has an interest is attributed to the person in question in determining whether a distribution from a corporation is in partial or complete liquidation of his interest in the corporation. These attribution rules (contained in sec. 318 of the code) not only are applicable in determining whether a stock redemption is to be treated as a dividend or as an exchange for stock (sec. 302) but also apply to numerous other situations as well. However, in these other cases, the applicability of the rules vary somewhat.

In the case of a stock redemption they provide that stock owned by, or for, a partnership, trust or estate or corporation (in the case of a corporation, however, only if the person has a 50-percent or greater stock interest) is to be considered as owned proportionately (pro rata, according to their interest) by the partners, beneficiaries or shareholders. This is what might be called a 'beneficial ownership' rule. In addition, stock owned by or for a partner or beneficiary or shareholder (again, in this latter case only if 50 percent or more of the stock is owned by the person) is considered for purposes of the dividend rule previously referred to as being owned by the partnership, estate, or corporation. This, in effect, is what might be considered an 'agency attribution' rule.

The operation of these two attribution rules together means, for example, that stock of a corporation held by a partner is considered to be stock held by any partnership of which he is a member (agency rule). This stock, which is considered to be held by the partnership, is then attributed (to the extent of his interest) to any other partner in the partnership (beneficial ownership rule). This double application of these rules has become known as sidewise attribution."

The Court seems to have misunderstood these Committee Reports, however, because the Court's Opinion cites them for precisely the opposite proposition: that even if the agency relationship no longer exists under state partnership law, "the attribution rules of § 318 are not dependent upon the existence of any agency relationship between the parties or entities." Appellant cannot conceive of any other rationale for attribution through a partnership. Surely, the Court does not believe that Congress arbitrarily adopted the fiction of constructive ownership for no reason at all. Appellant respectfully suggests that if the Court would again read the Committee Reports referred to it will find that Congress explicitly had in mind and relied upon the legal relationships of agency and beneficial ownership as the basis for partnership attribution when it enacted Section 318. Hence, the existence of such legal relationships must be regarded as the *sine qua non* for attribution.

Perhaps the Court was misled by appellant's argument that the 1964 amendment eliminating sidewise attribution should be regarded as an indication of Congressional intent. The Court may have thought that because the amendment was not made retroactive the discussion of agency and beneficial ownership in the Committee Reports did not apply to attribution before the effective date of the amendment. But the Committee Reports plainly refer to the *original rationale* for attribution when they discuss the agency and beneficial ownership rules.

In construing the requirements for partnership attribution in the context of this case, the Court also ignored the reason Congress made the benefits of Section 334(b)(2) dependent upon a purchase of stock from one whose stock was not attributed to the pur-

chasing corporation under Section 318. Section 318, as the aforementioned Committee Reports show, is designed to prevent tax avoidance in transactions between persons who have a common economic relationship. Thus, in referring to the attribution rules of Section 318 in Section 334(b)(3)(C), Congress intended to prevent possible tax avoidance by denying a new and higher basis for assets allegedly purchased by a corporation from a party who controlled the acquiring corporation (having 50% or more of the stock of such corporation), and, therefore, who should be presumed not to have been dealing at arms length. But the Tax Court's findings clearly establish that actual control of appellant by the Jerome Brothers did not exist, the parties in fact did deal entirely at arms length, and the price which they bargained for was fair.

Thus, the Court's interpretation of Sections 318 and 334(b)(3)(C) have produced an anomaly. Purely artificial "control" of appellant (30% actual plus 21.5% constitutional ownership), raising an admittedly false presumption that the parties did not deal at arms length, was created by a technical construction of the meaning of the term "partnership" which bears no relation to the economic realities of the situation. Yet the Court made no attempt to reconcile this patently unconscionable result with the statutory purposes. It is inconceivable that Congress intended that an arms length corporate transaction may be denied the normal tax treatment accorded such a transaction merely because the Court concluded an unrelated and dissolved partnership involving some of the stockholders had not been liquidated fully at the time such transaction was entered into. The Court was simply oblivious to the real Congressional objectives when it construed Sections 318 and 334(b)(3)(C) in this manner.

II.

**The Court Misunderstood the Legal Effect of a
Dissolution Under Partnership Law.**

Contrary to the Court's mistaken belief, we have shown in the preceding section of this Petition, as we did in our briefs, that it is the agency relationship inherent in a partnership which provides the reason for the partnership constructive ownership rules of Section 318. We also urged in our briefs that the cessation of business and sale of all of the assets of the partnership constituted, at the very least, a "dissolution" (as distinguished from a "termination") under California law and under general principles of partnership law. (In addition to the California authorities cited in our briefs, see 40 Am.Jur., Partnership, §243, p. 229.) We further argued that even though a partnership is regarded as continuing in existence after a dissolution, for the limited purpose of winding up its affairs, the unquestioned legal effect of the dissolution is to immediately destroy the agency relationship between the partners and the partnership as to any subsequent matters which are not related to the former partnership venture. Hence, after March 1, 1961, there was no legal relationship of agency between Manchester and its former partners, which could apply to the subsequent stock transactions involving appellant; and since the reason for the rule of partnership attribution no longer existed, such dissolved partnership cannot be regarded as "existing" within the meaning of Section 318.

In addition to its misconception that no agency relationship is required for partnership attribution, the Court seems to have completely misunderstood appellant's argument that the partnership agency with respect to Manchester was destroyed by the dissolution on March 1, 1961. In answer to appellant's argument

and authorities on this point, the Court merely repeated, in a footnote, the erroneous and irrelevant statements offered by the government in its brief to the effect that all of the cases relied upon by appellant were either prior to the adoption by California of the Uniform Partnership Act, or dealt with questions as to whether a particular partner was part of the partnership agency at a particular time. The Court then went on to say that appellant had ignored the Uniform Partnership Act sections which deal with the effect of a dissolution. We did not ignore them.

In our briefs, we attempted to make it clear that we fully recognized the distinction between in dissolution and a termination under partnership law; and that a partnership continues in existence after dissolution and is finally terminated only when all of the partnership's affairs have been wound up. But the real point which we were trying to make was that after a dissolution, but prior to termination, there is no agency relationship as to new matters. This is a long-settled principle of partnership law which was in no way changed by the Uniform Partnership Act.²

The following discussion from American Jurisprudence is illustrative of the point:

“While it is often said that the dissolution of a partnership terminates its existence, it is perhaps more accurate to say that dissolution denotes that change in the partnership relation which ultimately

²The authorities on which we relied included California cases decided well after adoption of the Uniform Partnership Act. Just to give one example, the case of *Credit Bureau of San Diego v. Beach*, (1956) 144 Cal.App. 439, cited in both of our briefs, stated (at p. 443): “When a partnership is dissolved the authority of one partner to create a new obligation for the partnership is revoked and his agency for his copartner ends.” This principle is not limited to a single partner; there is no agency among any of the partners after a dissolution.

culminates in its termination. It is true that except for the purpose of winding up the business of the firm, a partnership ceases to exist immediately upon dissolution; yet it is hardly necessary to cite authorities for the proposition that after dissolution a partnership is considered as maintaining a limited existence for the purpose of making good all outstanding engagements, of taking and settling all accounts, and collecting all the property, means, and assets of the partnership existing at the time of its dissolution, for the benefit of all interested. This principle is recognized in the Uniform Partnership Act. *Dissolution of a partnership terminates of course the general agency of partners growing out of the partnership relation, and implied power to act for the partnership, except so far as such agency and implied powers may be necessary to the winding up of the partnership business.*" (Emphasis Added.)

40 Am. Jur. Partnership §264, pp. 312-313.

Because of its misunderstanding of these principles, the Court did not deal with what are really the critical questions presented by appellant's argument here: does the limited existence of a partnership after dissolution, but prior to a final winding up, serve the statutory purpose for stock attribution through such partnership? If not, how can it still be a "partnership" within the meaning and intent of Congress when it enacted Section 318?

III.

The Court Misinterpreted Section 708 of the Internal Revenue Code and the Authorities on Which Appellant Relied in Connection Therewith.

In our briefs to the Court, we referred to Section 708 of the Internal Revenue Code and argued that Manchester Partnership “terminated” within the meaning of that Section. We pointed out, however, that the termination provisions of Section 708 are expressly limited to Subchapter K, dealing with partnership taxation (which does not include Section 318), and the factors relevant to termination for partnership tax purposes are quite different from those involved in the constructive ownership question. It should also be borne in mind that “termination” under Section 708 does not necessarily mean the same thing as a final termination (following dissolution and winding up) under normal partnership law.

It was, and still is, our position that if Manchester “terminated” under Section 708, it can no longer be regarded as existing for any tax purpose, including Section 318 purposes. But we also contended and contend that even if Manchester had not yet terminated under the technical requirements of Section 708, it nevertheless should not be regarded as existing for Section 318 purposes after “dissolution” under partnership law, for the reasons stated previously. The limited purposes for which a partnership may exist after dissolution, but prior to a technical termination of its tax liability under Section 708, have no relevance to constructive ownership under Section 318. The Court never discussed this alternative argument and merely held that there was no termination under Section 708.

Furthermore, the Court was in error in its understanding of Section 708 and the authorities on which

appellant relied in connection therewith. Our argument was that the cessation of business followed by a single sale of all of the partnership assets on March 1, 1961, constituted a sale of the entire partnership interests on that date. This is to be distinguished from a mere sale of assets by a partnership which thereafter continues carrying on a partnership business. A sale of the entire partnership interests results in an immediate termination of the partnership under Section 708(b)(1)(B). As authority for this argument, we relied upon *Hatch's Estate v. Commissioner*, 198 F.2d 26 (9th Cir. 1952); *Barran v. Commissioner*, 334 F.2d 58, 64-65 (5th Cir. 1964); and *James, et al. v. United States*, 63-1 U.S.T.C. Para. 9478 (D.C. Ga. 1963).

The Court's Opinion attempts to distinguish *Hatch* and *Barran* (without mentioning *James*). We submit that the grounds urged for such distinction are irrelevant. The Court's emphasis on the fact that those cases involved sales of a "going business," whereas Manchester's business had ceased to actively operate several months prior to the sale, misses the real point. In the instant case, just as in *Hatch* and *Barran*, assets which comprise the entire partnership business were sold in a single sale to an unrelated party which desired to take over and operate such business. Thereafter, Manchester no longer engaged in any business. Thus, the material facts are squarely within the rationale of *Hatch's Estate* and *Barran*. It makes no difference whatever that the partnership was forced, for financial reasons, to shut down operations before the assets were sold. It still sold a "business," rather than isolated assets.

We do not find anything in the *Barran* case to justify the Court's statement that after the sale there, no payments were paid to the partnership but cash was paid directly to the individual partners. The only monthly payments to the individual partners to which

we find reference in the opinions of the Tax Court and Court of Appeals were for separate covenants not to compete, signed by each of the partners in their individual capacity. There was also an unpaid balance of the purchase price for the partnership's assets after the sale date, but neither of the opinions indicated how such money was paid. The contract of sale recited that the money would be paid to the partnership. In any event, it is clear from the context of both *Barran* and *Hatch's Estate* that the precise technical manner in which the payment of the sale price is made, whether directly to the individuals or in the name of the partnership followed by distribution, has nothing to do with the principle on which those decisions are based.

In both *Hatch's Estate* and *Barran* some minor assets and cash were retained in the name of the partnership for some period after the sale. Failure to immediately liquidate and distribute these assets to the individual partners did not prevent the sale from operating to terminate the partnership. The question is, what was the intent of the parties as shown by the substance of the transaction. If they did not intend to carry on as a partnership after the sale of their assets, such sale is regarded as a sale of their interests in the partnership, terminating the partnership. There has never been any doubt that the partners in Manchester did not intend to carry on any further partnership business when, on March 1, 1961, they sold the *entire assets* of the partnership. They did not retain any assets for subsequent liquidation, as was true in *Hatch* and *Barran*. They did no more than collect and distribute the proceeds from the sale.

Nor does it matter that the final partnership return for Manchester was for the period ending August 31, 1962, and that returns for 1961 and 1962 were filed showing collections of the sale price. The

filing of such returns did not keep the partnership in existence after it terminated by reason of the sale. *Hatch's Estate v. Commissioner, supra*; Cf. *Avent v. Commissioner*, 76 F.2d 386 (5th Cir. 1935).³

The Court misplaced its reliance on the Tax Court's decision in *Foxman v. Commissioner*, 41 T.C. 353 (1964), affirmed on other grounds 352 F.2d 466 (3rd Cir. 1965). That case does not stand for the proposition that a partnership must sell a "going business" in order that it will be treated as a sale of the partnership interests, rather than a mere sale of assets. Moreover, there the Tax Court held that the subject partnership did not terminate after a sale of its assets because the partners engaged in activities thereafter which indicated an attempt to prevent a termination and an intent to carry on business as a partnership. This fact alone distinguishes *Foxman* from the instant case. Finally, the authority relied upon by the Tax Court in *Foxman* was its own decision in *Emmette L. Barran*, 39 T.C. 515-528, which was subsequently reversed on appeal on the very point for which it was cited. *Barran v. Commissioner, supra*.⁴

The Tax Court in *Barran* held that there was no termination under Section 708 because "There was a continuation of partnership activities after the sale of the bulk of the partnership assets, and at no time was there a sale . . . of any interest in the partnership profits." (39 T.C. at 528.) The Court stated (as did

³In view of the fact that the final return for the partnership was for a period ending August 31, 1962, there is absolutely no proper basis for the Court's conclusion that the partnership was still winding up its affairs at the time of the December 31, 1962, transaction.

⁴The Fifth Circuit's reversal of the Tax Court in *Barran* occurred on July 9, 1964, after the Tax Court had already decided *Foxman* on January 16, 1964.

this Court in the instant case) that there was no evidence in the record as to when the winding up and final liquidation of the partnership occurred. The Tax Court also purported to distinguish *Hatch's Estate* on the basis of differing language in the contracts of sale, noting (as did this Court in the instant case) that the contract of sale there under scrutiny referred only to assets. Hence, it was concluded that the sale was one of assets rather than the partnership interests. The Fifth Circuit Court of Appeals, in reversing the Tax Court on this question, said that the case was indistinguishable from *Hatch's Estate*. All of the partnership assets, except cash and a small piece of real property not used in the business, had been transferred to a purchaser which intended to operate the business formerly operated by the partnership. The Court of Appeals concluded (at p. 65):

“Moreover, the evidence shows no business activity whatsoever engaged in by the partnership after November 1, 1957 [the date of sale]; no income was generated after that time. Under these circumstances, we find that in substance the transaction was a sale of partnership interests, and the Tax Court erred as a matter of law in not so construing it. See, *Thornley v. Commissioner* . . . [147 F.2d 416, 420 (3rd Cir. 1945)]”

We submit that the instant case, like *Barran*, is indistinguishable from this Court's decision in *Hatch's Estate*. The Court's present attempt to distinguish *Hatch's Estate* and rely on *Foxman* is just as erroneous as was the Tax Court's attempt to do so in *Barran*. The transaction was a sale by Manchester of its entire partnership assets and the partners did not thereafter engage in any business activity. Hence, it was in substance a sale of the entire partnership interests.

A sale of over 50 per cent of the partnership interests automatically terminates the partnership on the date of the sale under Section 708(b)(1)(B), regardless of any so-called "winding up" which may occur thereafter. Reg. §1.708-1(b).⁵

IV.

Appellant Is Entitled to a Stepped Up Basis, Irrespective of Section 334(b)(2), Under the Kimbell-Diamond Doctrine. This Court's Decision Is in Conflict With That Case and With a Recent Decision of the Court of Claims.

It is undisputed that appellant purchased the stock of Old Baker and Kerman Tallow in 1961, and Veronica in 1962, for the express purpose of acquiring the assets of those corporations. In each case, the price was based on the value of the assets and did not include good will. Immediately after purchasing the stock, the acquired corporations were liquidated and the purchase price for the stock was allocated to the assets received in liquidation. Thus, a classic case is presented for an application of the doctrine that substance controls form, so that the transactions are treated for tax purposes as straight purchase of assets giving appellant a basis for such assets equivalent to their cost. The separate steps of purchasing stock and liquidation are in reality a single transaction. This was precisely the result reached

⁵Contrary to the Court's opinion, Manchester did not merely cease "engaging in its principal business activity." The evidence was undisputed that it engaged in no business activity after March 1, 1961. The only "winding up" involved, was collection, distribution and reporting of the proceeds of the final sale of its business and assets. In any event, a distinction must be drawn between a termination under Section 708(b)(1)-(B), which occurs on the date of sale, and a termination by reason of a mere cessation of business under Section 708(b)-(1)(A), which requires a complete liquidation and distribution.

under analogous facts in the landmark case of *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), affirmed per curiam, 187 F.2d 718 (5th Cir. 1951), cert. den. 342 U.S. 827.

Although the *Kimbell-Diamond* case was decided prior to the 1954 Internal Revenue Code, and in fact provided the rationale for Congress' inclusion of Section 334(b)(2) in the 1954 Code, a recent decision of the Court of Claims holds that *Kimbell-Diamond* remains viable in post 1954 Code years. The case is *American Potash & Chemical Corporation v. United States*, 339 F.2d 194 (Ct.Cl. 1968), on rehearing 402 F.2d 1000 (1968). It held that Congress' adoption of Section 334(b)(2) did not pre-empt the *Kimbell-Diamond* doctrine, and therefore, Section 334(b)(2) is not the exclusive mechanism for obtaining an exception to the carryover basis rules of Section 334(b)(1), which apply to the normal liquidation of a subsidaiary corporation by a parent.

Accordingly, even though the taxpayer in *American Potash* admitted failure to comply with Section 334(b)-(2), the Court remanded the case for a further trial to determine the presence or absence of the factual circumstances wherein the *Kimbell-Diamond* doctrine has been, or should be, applied. In this regard, the Court said (at p. 209):

"In general, it has been deemed applicable when an acquiring corporation planned from beginning to end (and had a subjective intent) to acquire assets of another corporation and, to obtain the assets, it either chose, or was required, to purchase the stock of the other corporation and liquidate. The stock purchase is an interim, transitory step in what is deemed a single unified purchase of assets."

The instant case presents an even stronger case for application of the *Kimbell-Diamond* doctrine than does *American Potash*. Here, the liquidation followed the stock purchases immediately. In *American Potash*, there was an interval of seven months.

Also, the reason for non-compliance with the technical requirements of Section 334(b)(2) in *American Potash* was that the stock was not acquired within the required period of 12 months, but rather extended over some 14 months. Hence, neither the express letter nor the purpose of the statute's technical limitations were met. By contrast, in the instant case, the purpose of the statute was squarely met. It is only the Court's technical construction of Sections 318 and 334(b)(3)(C)—without any relevance to the purpose for such limitations—which prevents literal compliance with Section 334(b)(2).

We believe the Tax Court's findings and the undisputed facts of this case conclusively establish that the requirements for an application of the *Kimbell-Diamond* doctrine are present. At the very least, however, the Court should remand the case to the Tax Court for a further determination of the necessary factual issues, as the Court of Claims did in *American Potash*.

We recognize that this argument is being raised for the first time in this proceeding. However, we did not have the benefit of the *American Potash* case when the matter was decided by the Tax Court; and the report of the Court of Claims' decision had only reached the advance sheet stage by the time our appellate briefs were filed and we were unaware of it. In any event, it is certainly not too late to raise the point. One of the purposes of the Rehearing procedure is to permit parties to call to the Court's attention recent developments in the law which were not considered in the briefs

or in the Court's opinion, and which have a material bearing on the proper disposition of the matter. Unquestionably, under these circumstances, substantial justice requires that this question be considered by the Court. To refuse, would merely add one more technical justification for an unconscionable tax result which may well cause the financial ruin of this appellant.

Respectfully submitted,

HILL, FARRER & BURRILL,
CARL A. STUTSMAN, JR.,
JACK R. WHITE,
GILLIN & SCOTT,
GLENN M. ALPERSTEIN,
Attorneys for Appellant.

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Certificate.

I hereby certify that in my judgment the petition for rehearing is well founded and further certify that it is interposed for delay.

JACK R. WHITE

